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Supreme Court, U.S.
FILED

10 13 11 APR 22 2011

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No.

In the

Supreme Court of the United States

BLUE BELL CREAMERIES, LP,
Petitioner,

v.

RICHARD ROBERTS, COMMISSIONER
DEPARTMENT OF REVENUE,
STATE OF TENNESSEE,
Respondent.

On Petition for Writ of Certiorari to the Supreme Court of Tennessee

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether it is a violation of the Commerce Clause and the Due Process Clause of the Fourteenth Amendment for a state to impose a tax on a stock redemption by petitioner's out-of-state parent and declare unitary a pure holding company and petitioner, its operating subsidiary, without applying the tests established by this Court under the unitary business principle.

PARTIES TO THE PROCEEDINGS

The parties before the Court are petitioner Blue Bell Creameries, LP, ("Petitioner" or "Blue Bell") and respondent Richard Roberts, Commissioner, Department of Revenue, State of Tennessee (the "Department").

RULE 29.6 STATEMENT

Petitioner Blue Bell Creameries, LP, is a wholly owned subsidiary of holding company Blue Bell Creameries, USA, Inc. ("BBC USA"). No public company has any ownership interest in Blue Bell Creameries, LP, or holding company BBC USA.

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PETITION FOR WRIT OF CERTIORARI

Blue Bell Creameries, LP, respectfully petitions that a writ of certiorari issue to review the judgment and opinion of the Tennessee Supreme Court in this case.

OPINIONS BELOW

The opinion of the Supreme Court of Tennessee was filed on January 24, 2011, and is reported at *Blue Bell Creameries, LP v. Richard Roberts, Commissioner, Department of Revenue, State of Tennessee*, _____ S.W. 3d ____, and is available at 2011 WL 198514 (Tenn.) (App. 1a – 27a).

The unreported opinion of the Court of Appeals of Tennessee in *Blue Bell Creameries, LP v. Lauren Chumley, Commissioner, Department of Revenue, State of Tennessee*, was filed on September 29, 2009, and is available at 2009 WL 3126249 (Tenn. Ct. App.) (App. 28a – 58a).

The relevant unpublished memorandum opinions of the Chancery Court for the State of Tennessee, 20th Judicial District, in this case were filed on August 15, 2008 (App. 86a – 91a), and on November 13, 2008 (App. 62a – 85a).

JURISDICTION

This Petition seeks review of the judgment of the Supreme Court of Tennessee which was entered on January 24, 2011. This petition is filed within ninety (90) days of the judgment of the Supreme Court of

Tennessee, pursuant to 28 U.S.C. § 2101(c) and U.S. Supreme Court Rule 13.1.

The jurisdiction of this Court to review the judgment of the Supreme Court of Tennessee is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL PROVISIONS INVOLVED

United States Constitution, Article I, Section 8, Clause 3:

Congress shall have power to regulate commerce... among the several states....

United States Constitution, Amendment XIV, Section 1:

No state... shall... deprive any person of life, liberty, or property, without due process of law....

STATEMENT OF THE CASE

This case concerns the federal constitutional limits on a state's ability to tax income generated outside its borders by a pure holding company with no connection to the taxing state other than the petitioner, an operating subsidiary that conducts a separate and discrete business in the taxing state. The specific issue raised in the case is whether a pure holding company, with no operational functions of its own, is unitary with its operating subsidiary simply because of the single underlying business activity of the operating subsidiary, with no consideration given to the tests developed by this Court under the unitary business principle.

Petitioner Blue Bell is an operating entity that produces, distributes, and sells ice cream in the state of Tennessee. On January 1, 2001, Blue Bell received stock in holding company BBC USA as part of an extraordinary, one-time reorganization transaction by holding company BBC USA. The stock was immediately redeemed by the holding company and all of the gain from the stock redemption was allocated to shareholders of holding company BBC USA. The Department determined that the gain Blue Bell realized and recognized for the stock redemption transaction was "business earnings" and therefore should be included in Blue Bell's apportionable income for excise tax purposes.

The primary issue in this case is whether the Department's tax on the gain from the stock redemption transaction is constitutional. In order to make this determination, the Chancery Court, the Tennessee Court of Appeals and the Tennessee Supreme Court were asked to decide, based on the uncontested material facts, whether taxpayer Blue Bell and holding company BBC USA are a unitary business.[1]

Blue Bell filed suit to recover the tax assessed by the Department and raised federal constitutional issues in its complaint, challenging the Department's

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[1] A secondary issue in the case below was whether the gain realized by Blue Bell in the extraordinary, one-time stock redemption transaction should be classified as "business earnings" or "nonbusiness earnings" under Tenn. Code Ann. § 67-4-2004. As this issue involves matters of state law, and should be rendered moot by the federal constitutional issues, this issue is not a part of this petition.

tax because there was an insufficient connection between the gain from the stock redemption transaction and the State of Tennessee. Blue Bell asserted that the Commerce Clause and the Due Process Clause of the Fourteenth Amendment prohibit a state from taxing value earned outside its borders and that Tennessee is prohibited from taxing value or income that, in all fairness and consistent with the U.S. Constitution, cannot be attributed to taxpayer Blue Bell's business activities in Tennessee.

The parties filed cross-motions for summary judgment in the Chancery Court. Following initial oral argument, the Chancery Court issued a Memorandum and Order dated August 15, 2008, directing the parties to submit supplemental briefs to assist the court in analyzing the "functional integration" between Blue Bell and BBC USA. (App. at 90a – 91a). The Chancery Court asked the parties to identify "the concrete tax advantages and non-reporting and non-registering of securities advantages plaintiff received from the stock redemption." *Id.*

Thereafter, the Chancery Court issued a Memorandum Opinion on November 13, 2008, granting Blue Bell's Motion for Summary Judgment and denying the Department's Motion on the grounds "plaintiff and BBC USA are not a unitary business and that the operational function test is not met." (App. at 75a – 76a). The Chancery Court found that the Department's tax on "the capital gains the plaintiff realized from the redemption transaction in issue

violates the federal Constitution." (App. at 76a).[2] A final judgment was entered on January 5, 2009, and the Department timely filed a Notice of Appeal to the Tennessee Court of Appeals on January 30, 2009.

On September 29, 2009, the Tennessee Court of Appeals issued an opinion affirming the judgment of the Chancery Court, finding that taxpayer Blue Bell was not in a unitary business relationship with its holding company parent BBC USA and, consequently, that the Department's tax assessment was unconstitutional. *Blue Bell Creameries, LP v. Chumley*, 2009 WL 3126249 (Tenn. Ct. App. 2009). (App. at 29a). The Court of Appeals further found that gains from the stock redemption transaction were not used as "operational funds" but were distributed to the holding company's shareholders. (App. at 56a). Thus, under the "operational function" test, the Department was not constitutionally permitted to assess a tax on taxpayer Blue Bell's non-operational earnings. (App. at 56a).[3]

The Department timely filed a Rule 11 Application for Permission to Appeal this case to the Tennessee Supreme Court on November 25, 2009. The Supreme Court granted the Department's Rule 11 Application

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[2] The Chancery Court addressed the state tax "business earnings" issue for purposes of appeal, but expressly found that the federal constitutional issues were dispositive of the case.

[3] The Court of Appeals also ruled that the issue regarding the classification of taxpayer Blue Bell's earnings as "business earnings" under state law was rendered moot by the Court's finding that the Defendant's tax assessment was unconstitutional. (App. at 56a).

on February 22, 2010, and heard the case on June 3, 2010. The Tennessee Supreme Court found, *inter alia*, that the stock redemption transaction was unitary with Blue Bell's ice cream business and that the tax by the Department did not violate the Due Process and Commerce Clauses of the U.S. Constitution. (App. at 24a).[4]

REASONS FOR GRANTING THE WRIT

I. THE TENNESSEE SUPREME COURT'S DECISION CONFLICTS WITH LONGSTANDING PRECEDENT FROM THIS COURT REQUIRING AN IN-DEPTH FACTUAL ANALYSIS OF THE NEXUS BETWEEN THE TAXING STATE AND THE PERSON, PROPERTY OR ACTIVITY IT SEEKS TO TAX.

The application of the unitary business principle in the context of a pure or passive holding company has not been directly addressed by this or any other federal court nor by the highest court of any other state. As a result, there is little guidance to direct states on how to handle this significant issue. Left without such guidance, the Tennessee Supreme Court chose to disregard the well-established tests developed by this Court under the unitary business principle in favor of a cursory analysis that the holding company parent and the operating subsidiary are unitary because both entities derive their income from a "single underlying

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[4] Unlike the Chancery Court and the Tennessee Court of Appeals, the Tennessee Supreme Court first took up the state law issue – determining that the gains from the stock redemption transaction were "business earnings" under the state statute – before turning its attention to the dispositive federal constitutional issue. (App. at 9a).

activity." The Tennessee Supreme Court did not engage in an in-depth factual analysis designed to determine whether a sufficient significant or palpable connection exists between the taxing state and the person, property or transaction the taxing state seeks to tax. The unitary analysis by the Tennessee Supreme Court focuses exclusively on the flow of income or economic benefit from the operating subsidiary to the holding company parent. The result, in essence, amounts to a *per se* rule that all non-operating holding companies will be unitary with their operating subsidiaries. Such a rule, if allowed to stand, will result in a broad expansion of the taxing reach of the states by removing the substantial nexus/minimal connection requirements for pure holding companies under the unitary business principle.

Substantial Nexus/Minimal Connection Requirements.

A state may tax interstate commerce consistent with the Commerce Clause of the U.S. Constitution if (1) the tax is applied to an activity with a "substantial nexus" to the taxing state, (2) the tax is fairly apportioned, (3) the tax does not discriminate against interstate commerce, and (4) the tax is fairly related to the services provided by the taxing state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). A state tax on interstate commerce will likewise withstand scrutiny under the Due Process Clause of the Fourteenth Amendment if there is some minimal connection between the person, property or transaction to be taxed and the taxing state, as well as a "rational relation" between the income attributed to the taxing state and the intrastate value of the business. *Allied*

Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 772 (1992).

Tennessee, like some other states, taxes business income of multi-state corporations using the apportionment method set forth in the Uniform Division of Income for Tax Purposes Act ("UDIPTA"). *Louis Dreyfuss Corp. v. Huddleston*, 933 S.W. 2d 460, 466 (Tenn. Ct. App. 1996). As long as there is "some definite link, some minimal connection" between the taxing state and the person, property or transaction it seeks to tax, the apportionment method is consistent with the Due Process Clause of the Fourteenth Amendment. *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992). The "substantial nexus" requirement under the Commerce Clause is designed to mitigate the effects of state regulation on the national economy and alleviate potential burdens on interstate commerce that would arise out of unfettered taxation on multi-state corporations by the states. *Quill Corp.*, 504 U.S. at 313. Both constitutional requirements can be satisfied when the taxing power exerted by the state bears fiscal relation to the "protection, opportunities and benefits" given by the state. *Allied-Signal, Inc.*, 504 U.S. at 778. The "connection" or "link" with the taxing state must be to the activity itself, rather than "a connection only to the actor the State seeks to tax." *Id.* In short, the relevant inquiry should be "whether the state has given anything for which it can ask return." *ASARCO Inc. v. Idaho Tax Comm'n,* 458 U.S. 307, 315 (1982).

The Unitary Business Principle

The "linchpin" of the apportionment method is the judicially created "unitary-business principle." *Mobil*

Oil Corp. v. Commissioner of Taxes of Vt., 445 U.S. 425, 439 (1980). This Court developed the unitary business principle to assist with analyzing the often complex issue of determining whether there is a connection or nexus between the taxing state and the person, property or activity it seeks to tax. *Allied Signal*, 504 U.S. at 777-778. Beginning in 1980 with *Mobil Oil Corp.*, and continuing through the 2008 decision in *MeadWestvaco Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16 (2008), this Court developed and fine-tuned the unitary business principle to address a wide range of circumstances. The common denominator in all of these decisions has been an overriding effort to engage in a fact-intensive analysis to ensure that the constitutional limitations are met under each new set of facts or circumstances. This Court is now presented with a situation that has yet to be addressed under the unitary business principle — the pure or passive non-operating holding company.

The difficult issue presented by a non-operating pure holding company like BBC USA is that pure holding companies have no business operations of their own and serve only to hold assets for various subsidiaries. However, the existence of a pure holding company in a constitutional tax challenge should not absolve a court from engaging in a constitutionally required nexus analysis to determine whether a sufficient connection exists to justify a state taxing value generated or earned outside its borders. The pure holding company situation demands the same sort of careful, fact intensive scrutiny this Court has applied to prior decisions under the unitary business principle.

Over the years, this Court has developed a number of tests for determining whether a business is unitary. The most prevalent test, the "hallmarks of unity," requires courts to examine the record for evidence of functional integration, centralized management, and economies of scale. *F.W. Woolworth Co. v. Taxation and Revenue Dep't*, 458 U.S. 354, 364 (1982); *Mobil Oil Corp.*, 445 U.S. at 438. This Court has also used a "dependency and contribution" test to determine whether the business components under consideration contribute to each other and the operations of the business as a whole. *Barclays Bank PLC. v. Franchise Tax Bd.*, 512 U.S. 298, 304 n. 1 (1994). In the "three unities" test, two separate business entities will form a unitary business if there is "(i) unity of ownerships; (ii) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (iii) unity of use of its centralized executive force and general systems of operation." *Butler Bros. v. McColgan*, 315 U.S. 501, 508 (1942).

Rather than applying any of these well-established tests, the Tennessee Supreme Court summarily rejected them by simply concluding that the tests are "ill-suited" for analyzing a non-operating, pure holding company and its operating subsidiary, saying that all three tests require a comparison of the relationship of the separate business entities' business operations. (App. at 24a). Instead of the traditional analysis under *Mobil Oil Corp.* and its progeny, the Tennessee Supreme Court focused on whether the two entities "derive their income from a single underlying activity." (App. at 23a).

Under this "single underlying activity" analysis, the Tennessee Supreme Court found that Blue Bell and holding company BBC USA are unitary because "both entities derive their income from a single underlying activity" – the production, sale and distribution of ice cream by Blue Bell. (App. at 23a). Based on this logic, non-operating, pure holding companies will always be unitary with their operating subsidiaries because non-operating, pure holding companies do not have separate - or any - business operations of their own, and derive their income from the underlying activity of their operating subsidiaries.

The decision of the Tennessee Supreme Court to analyze a unitary business relationship under the "single underlying activity" analysis creates in effect a *per se* rule which is contrary to the Commerce Clause and the Due Process Clause of the Fourteenth Amendment. The Tennessee Supreme Court's decision places an undue emphasis on the economic benefit or "flow of income" from the subsidiary to the parent at the expense of a fact-intensive inquiry focusing the "rational relationship" between the gain from the stock redemption and Blue Bell's business activities in Tennessee. There must be some actual, concrete advantages conferred on the operating subsidiary's business activities by the holding company's reorganization and stock redemption transaction. Here, there are none.

This Court has previously rejected a similar "flow of income" analysis that relied on the income from a subsidiary to a parent as a sufficient basis to establish the requisite constitutional nexus. In *F.W. Woolworth Co., v. Taxation and Revenue Dep't*, 458 U.S. 354 (1982), this Court found that a parent company's

receipt of income from subsidiaries was not, by itself, a sufficient basis to establish a unitary business. *Id.* at 363. Income, from whatever source, is a "business advantage" to any corporation. *Id.* To hold that the constitutional requirement of substantial nexus and minimal connection are satisfied merely because the income from a subsidiary "adds to the riches of the [parent] corporation" would "trivialize" the due process limitations on the taxing reach of the state. *Id.* The unitary business principle "demands more." *Id.* The income at issue must be "rationally related" to "values connected to the taxing state." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978) *quoting Norfolk & Western R. Co. v. State Tax Comm'n*, 390 U.S. 317, 325 (1968).

The proper inquiry is to look to the unity or diversity of the business enterprise pursuant to the tests under the unitary business principle, and "not to whether the non-domiciliary parent derives some economic benefit – as it virtually always will – from its ownership of" another company. *F.W. Woolworth Co.* 458 U.S. at 364-365. Reliance on the "flow of income" from the underlying business activity of Blue Bell to holding company BBC USA, without more, would "trivialize" the due process limitations on the State's taxing reach because the holding company parent will always derive economic benefit from its operating subsidiaries. *Id.* at 363. Something more is required. *Id.*

That "something more" is any benefit or advantage conferred on the wholly owned operating subsidiary's business activities in the taxing state by the holding company's stock redemption. The Tennessee Supreme Court's focus on the underlying activity generating

income is misplaced. Tennessee imposed a tax on income generated by the holding company BBC USA's stock redemption transaction, which took place outside of Tennessee and benefitted the holding company's out-of-state shareholders. The stock redemption funds were not generated by Blue Bell's production, sale and distribution of ice cream in Tennessee and did not have any rational relation to values connected with Tennessee. In its constitutional analysis, the Tennessee Supreme Court does not identify any concrete connection between the income upon which the state imposed the tax – the stock redemption gain – and any benefit conferred on Blue Bell or its in-state business activities. In fact, the gain did not benefit Blue Bell or Blue Bell's business activities in Tennessee at all. The unitary business principle requires "some sharing or exchange of value...beyond the mere flow of funds arising out of a passive investment or a distinct business operation." *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 166 (1983). In its constitutional analysis, the Tennessee Supreme Court should have examined whether BBC USA's reorganization and stock redemption transaction provided any value or concrete business advantages to Blue Bell in its production, sale and distribution of ice cream, the activity carried out in Tennessee, which, in turn, would establish a sufficient nexus to justify Tennessee's taxing reach in this case.

This Court has previously rejected "bright-line" tests similar to the one fashioned by the Tennessee Supreme Court in this case. In *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983), this Court refused to adopt a "bright-line" test for unitariness based on the "flow of goods" between a parent and a

subsidiary. *Container Corp.*, 463 U.S. at 178, n. 17. "The prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not a flow of goods." *Id.* at 178 (emphasis in original). By the same reasoning, a "single underlying activity" generating income should not be a sufficient basis, standing alone, to establish a unitary business. An in-depth analysis into whether there has been a "flow of value" from the parent to the subsidiary that contributes to the taxpayer's business activities in the taxing state is necessary. Such a flow of value can exist between a pure holding company parent and its operating subsidiary, if not through functional integration, centralized management and economies of scale, then through such things as shared tax benefits, insulation from liability, inter-company financing, and improved credit worthiness. Courts must endeavor to find these substantial connections in a given case before upholding the constitutionality of a state's taxing reach, and not rely on a simple "flow of income" analysis.

Analyzing Pure Holding Companies Under the Unitary Business Principle

While the pure holding company presents a challenge in the unitary business principle application, the difficulty in undertaking the inquiry does not warrant the establishment of "short cuts" in the place of substantive constitutional analysis. The constitutional analysis may be difficult, but it can be done. Both the Chancery Court and the Tennessee Court of Appeals applied the tests under the unitary business principle and found the imposition of the tax unconstitutional. A straight application of the "hallmarks of unity", for example, may not present a

precise fit with a non-operating holding company, but the purpose behind the various tests – establishing unity or lack thereof by examining the flow of value conferred on the entity conducting business in the taxing state by its out-of-state parent – can still be accomplished even when the parent company is a non-operating, pure holding company.

Both the Chancery Court and the Tennessee Court of Appeals found a California Board of Equalization case to be instructive on the issue of analyzing the unitary business principle in the context of pure holding companies. In *In Re PBS Building Systems, Inc. et. al.*, 1994 Cal. Tax Lexis 434 (Nov. 17, 1994), the California Board of Equalization determined that there was no *per se* rule regarding unitariness or nonunitariness of holding companies. *Id.* at *7. The California Board of Equalization made it clear that there is no separate standard or higher burden of proof and no special tests or analysis to determine whether holding companies and operating companies are unitary. The standard tests for unitariness should suffice. *Id.*

In the case of pure or passive holding companies, the typical characteristics of unity may not exist. Therefore, the pure holding company context requires a court to focus on the economic realities of a particular corporate structure in determining whether a holding company and its operating subsidiary are unitary. Factors which might be considered relatively insignificant in analyzing unity for vertically or horizontally integrated corporations may take on added importance in the holding company context. Factors such as shared tax benefits, inter-company financing (loans, loan guarantees, and debt

retirement), and improved credit worthiness (bond security, favorable insurance ratings, or interest rates on borrowed capital), take on added significance in a holding company context. *Id.* at 14. The finding of unitariness necessarily requires "some sharing or exchange of value... beyond the mere flow of funds arising out of a passive investment or a distinct business operation." *Container Corp.*, 463 U.S. at 166. Furthermore, there must be something more than the type of occasional oversight that any parent gives to an investment in a subsidiary. *F.W. Woolworth Co.*, 458 U.S. at 369.

The underlying unity or diversity of the business does not necessarily depend on the form or structure of its organization. *Mobil Oil Corp.*, 445 U.S. at 440. The finding of unity is also not dependent upon the business's "purpose". *ASARCO Inc.*, 458 U.S. at 326. The proper purpose of any unitary business analysis is the relationship between the activities of the taxpayer in the taxing state and the activities occurring elsewhere, and not just on common relationships between the various components or entities and the central structure of the business itself. *Louis Dreyfuss Corp.*, 933 S.W. 2d 467. A *per se* rule that all non-operating holding companies are unitary with their operating subsidiaries simply because a flow of income from the subsidiary to the parent places undue emphasis on the form and structure of an organization, common relationships and the purpose of a business, at the expense of any real or concrete connection (or lack thereof) with the business activities in the taxing state.

Under existing law, the unity or diversity of a business does not depend on whether the earnings of

the business's components ultimately add value to the entire business. *F.W. Woolworth Co.*, 458 U.S. 354, 363 (1982). What is important is that the income to be taxed must have been earned in the course of activities related to those carried out by the taxpayer in the taxing state. *Allied-Signal, Inc.*, 504 U.S. at 787. In order to determine whether unity exists, a court should consider different aspects of the business in relation to the taxable transaction at issue – here, the stock redemption transaction. *Allied-Signal, Inc.*, 504 U.S. at 781. Yet, under the Tennessee Supreme Court's analysis, the mere fact that the operating subsidiary provides income to the pure holding company parent would end a court's analysis, regardless of whether the out-of-state holding company has any operational link to its in-state subsidiary, or whether the transaction at issue served any sort of operational function for the subsidiary.

The Operational Function Analysis.

The Tennessee Supreme Court began its federal constitutional analysis by first determining the stock transaction/reorganization is unitary with the taxpayer's ice cream business in Tennessee. In its application of the "operational function" test, the Tennessee Supreme Court found that BBC USA's stock transaction and reorganization did not affect Blue Bell's production, sale and distribution of ice cream in Tennessee. While the stock redemption transaction may have "reduced expenses that detracted from the earnings arising from the sale of Blue Bell ice cream in Tennessee" (App. at 17a), the benefit of this transaction was realized by the holding company and its shareholders and not the operating subsidiary in

the taxing state. Therefore, the stock redemption transaction did not serve an operational function.

The Tennessee Supreme Court states that an asset serves an "operational function" if the asset helps the taxpayer "make better use of the taxpayer's existing business-related resources." (App. at 20a – 21a). The Tennessee Supreme Court cites this Court's decision in *Container Corp.*, 463 U.S. 159, 178 (1983), in support of this definition of an "operational function" asset. However, what this Court found in *Container Corp.* is that a parent's "contributions to income" to a subsidiary creates a constitutionally acceptable finding of unitary business where there is a flow of "value not a flow of goods" from the parent to the subsidiary. *Id.* Specifically, a parent's "contributions to income" to a subsidiary creates a unitary business when the "contributions to income" allow the subsidiary to make better use, either through economies of scale or through operational integration or sharing of expertise, of the parent's existing business related sources.

In the present case, any "contributions to income" by holding company BBC USA to its operating subsidiary, the taxpayer, do not create economies of scale or operational integration or sharing of expertise because the holding company BBC USA is a non-operating entity. There is no "flow of value" between holding company BBC USA and its operating subsidiary. As this Court has pointed out time and again, the relevant question in the unitary business inquiry is whether "contributions to income [of the subsidiary] result[ed] from functional integration, centralization of management, and economies of scale."

Id.; *F.W. Woolworth*, 458 U.S. at 364, quoting *Mobil Oil Corp.*, 445 U.S. at 438.

There is nothing in the record here to establish that the holding company BBC USA had any connection to Tennessee other than its separate and distinct operating subsidiary. More importantly, there is nothing in the record to connect the income generated by the stock redemption transaction to Blue Bell's production, sale and distribution of ice cream in the State of Tennessee. The stock in the privately held holding company was owned outside the borders of Tennessee and the gain generated by the stock redemption transaction flowed to the benefit of the holding company's out-of-state shareholders. The income in the stock redemption transaction was not earned in the course of Blue Bell's business activities in Tennessee. Tennessee has extended its taxing reach beyond its borders to tax value generated outside of Tennessee. The tax imposed by the Department is unconstitutional and should be set aside.

II. THE SUPREME COURT OF TENNESSEE HAS DECIDED AN IMPORTANT FEDERAL CONSTITUTIONAL QUESTION—THE APPLICATION OF THE UNITARY BUSINESS PRINCIPLE TO A PURE HOLDING COMPANY—THAT HAS NOT BEEN, BUT SHOULD BE, SETTLED BY THIS COURT.

The Tennessee Supreme Court has decided an important constitutional issue in a way that conflicts with relevant decisions of this Court. The application of the unitary business principle to pure holding companies is a significant federal constitutional issue that has not been, but should be, settled by this Court. Petitioner urges this Court to grant this Petition and address this significant issue.

This Court has previously determined that its limited role in reviewing a constitutional challenge to a state's taxing reach is to "determine whether the state court applied the correct standard" and whether the state court's judgment was "within the realm of permissible judgment." *Container Corp.*, 463 U.S. 159, 176 (1983). While the legal parameters of the unitary business principle are well-established, the *Blue Bell* case presents this Court with a challenge beyond the mere application of existing law to a previously considered set of facts.

The Tennessee Supreme Court failed to apply the appropriate and correct standards of the unitary business principle in this case. Nothing in the case law developed by this Court over the last thirty years suggests that a non-operating, pure holding company should be treated or evaluated any differently than a fully functional operating parent company under the unitary business principle. While this Court has upheld a wide variety of constitutionally acceptable variations on the unitary business principle, each prior case has been subjected to careful scrutiny to determine whether there is a sufficient nexus or connection to justify the state's taxing reach under the Commerce Clause and the Due Process Clause of the Fourteenth Amendment. Prior cases have rejected *per se* rules or "bright line" tests in favor of substantive analysis. The same rigorous application of the unitary business principle should be applied in the context of non-operating, pure holding companies.

Pure holding companies are an increasingly common structure in the national and international business community. The wide use of pure holding companies in a variety of industries and business

settings will undoubtedly create situations in the future in which a state will seek to impose a tax on income generated outside of its borders by a holding company.

The lack of any controlling, relevant authority will result in any number of differing approaches to the constitutional issues raised in this case. This underscores the need for this Court to accept this case and resolve this issue. The constitutional requirement of a nexus between the taxing state and the person, property or activity it seeks to tax applies regardless of whether the holding company is a functionally integrated operating entity as in *Mobil Oil Corp.*, or a pure holding company as in the present case. The lack of controlling authority specific to pure holding companies has resulted, at least in this case, in a constitutionally impermissible tax on petitioner.

Applying the unitary business principle should be a fact-intensive process requiring a careful analysis to the operation of the business enterprises at issue. *Allied-Signal*, 504 U.S. at 785; *ASARCO Inc.*, 458 U.S. at 329. The endless variety of business enterprises, and the dearth of clear, controlling precedents for the application of the unitary business principle to pure holding companies may result in the imposition of conflicting tax obligations on multi-state corporations and future court decisions contrary to existing precedent from this Court and the mandates of the Constitution itself.

CONCLUSION

For the reasons set forth above, the Petitioner respectfully submits that this petition should be granted, and a writ of certiorari issue to review the decision of the Tennessee Supreme Court.

Respectfully submitted,

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APPENDIX A

IN THE SUPREME COURT OF TENNESSEE
AT NASHVILLE
June 3, 2010 Session

No. M2009-00255-SC-R11-CV

[Filed January 24, 2011]

BLUE BELL CREAMERIES, LP	)
	)
v.	)
	)
RICHARD ROBERTS, COMMISSIONER, DEPARTMENT OF REVENUE, STATE OF TENNESSEE	)

Appeal by Permission
from the Court of Appeals, Middle Section
Chancery Court for Davidson County
No. 06-414-III Ellen H. Lyle, Chancellor

Taxpayer is a Delaware limited partnership that produces, sells, and distributes ice cream in Tennessee and elsewhere. At issue in this appeal is the Tennessee Department of Revenue's excise tax assessment on capital gains from a one-time stock transaction between Taxpayer and its holding company. Taxpayer sought a refund in chancery court, challenging the validity of the tax assessment on statutory and federal constitutional grounds. Both Taxpayer and the

Department moved for summary judgment. The chancery court granted summary judgment to Taxpayer, and the Court of Appeals affirmed the judgment. Based on the uncontested facts in the record, we hold that Taxpayer's capital gains were business earnings pursuant to the functional test provided in Tennessee Code Annotated section 67-4-2004(1) (Supp. 2000) and therefore subject to the excise tax. Additionally, we hold that the tax assessment was constitutional pursuant to the unitary business principle. We therefore reverse the judgment of the Court of Appeals and enter summary judgment for the Department. We remand to the trial court to determine the amount of excise tax related to Taxpayer's capital gains.

Tenn. R. App. P. 11 Appeal by Permission; Judgment of the Court of Appeals Reversed; Summary Judgment Granted; Case Remanded

JANICE M. HOLDER, J., delivered the opinion of the Court, in which CORNELIA A. CLARK, C.J., and GARY R. WADE, WILLIAM C. KOCH, JR., AND SHARON G. LEE, JJ., joined.

Robert E. Cooper, Jr., Attorney General and Reporter; Michael E. Moore, Solicitor General; Brad H. Buchanan, Assistant Attorney General, for the appellant, Richard Roberts,[1] Commissioner of Revenue, State of Tennessee.

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[1] In accordance with Tennessee Rule of Appellate Procedure 19(c), Richard Roberts, the current Commissioner of Revenue, has been substituted for his predecessors, Charles A. Trost, Reagan Farr, and Loren L. Chumley.

James Campbell Bradshaw, Nashville, Tennessee, for the appellee, Blue Bell Creameries, LP.

Joe Barnett Huddleston, Washington, D.C., for the amicus curiae, Multistate Tax Commission.

OPINION

I. Facts and Procedural History[2]

Blue Bell Creameries, LP ("Taxpayer") is a Delaware limited partnership with its principal place of business in Texas. It produces, sells, and distributes Blue Bell ice cream in Tennessee and elsewhere. On February 14, 2006, Taxpayer filed a complaint in the chancery court in Davidson County alleging that the Tennessee Department of Revenue ("the Department") improperly taxed Taxpayer's capital gains from Taxpayer's acquisition and sale of 1,131 shares of stock on January 1, 2001 ("the Stock Transaction"). The Stock Transaction was one part of a reorganization of the business entities that own Taxpayer and profit from the Blue Bell ice cream business. The material aspects of the reorganization, including the Stock Transaction, occurred on January 1, 2001.

Prior to January 1, 2001, Taxpayer's predecessor corporation, which produced, distributed, and sold Blue Bell ice cream, was a subsidiary of Blue Bell Creameries, USA, Inc. ("BBC USA"), a holding company. BBC USA owned the two subsidiaries that owned Taxpayer's predecessor organization. The

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[2] Facts in Part I are from the parties' statements of undisputed facts and the documents cited therein.

profits realized by Taxpayer's predecessor organization inured to the benefit of BBC USA and its stockholders. BBC USA existed only to own the assets and properties of the related businesses and legal entities that operated the Blue Bell ice cream business. This structure permitted the holding company to channel profits from the Blue Bell ice cream operation to its stockholders without incurring a Texas franchise tax. The profits from the Blue Bell ice cream business were subject to two federal income taxes, one assessed on the holding company's income and one assessed on stockholders' dividend income from their stock in the holding company.

The board of directors of BBC USA decided to reorganize to qualify as an S corporation taxed pursuant to subchapter S of the Internal Revenue Code. 26 U.S.C. §§ 1361-79 (2006). Election as an S corporation permits business entities to obtain "pass-through" tax treatment so that only the entity's owners are subject to federal taxes on the entity's income. BBC USA formed Taxpayer as a limited partnership, which allowed all income generated from the Blue Bell ice cream business to be subject to pass- through tax treatment. BBC USA also structured its other subsidiaries to provide pass-through tax treatment for income from the Blue Bell ice cream business. On January 1, 2001, the holding company caused all of the assets and liabilities of Taxpayer's predecessor organization, including operations for the Blue Bell ice cream business, to be transferred to Taxpayer.

Federal statutes governing the S corporation election required that S corporations have no more than seventy-five stockholders. 26 U.S.C. § 1361(b)(1)(A) (2000) (amended 2004). To satisfy this

requirement, BBC USA permitted seventy-five stockholders to retain their ownership in BBC USA. BBC USA then permitted certain stockholders who could not retain their ownership in BBC USA to exchange all of their shares for an equivalent number of shares in the limited partnership interest of Taxpayer.

Approximately 250 stockholders contributed 1,131 shares of BBC USA to Taxpayer to obtain shares in Taxpayer equaling 29% of the limited partnership. BBC USA then redeemed the 1,131 shares of stock contributed to Taxpayer for $142,506,000. This price was set by BBC USA's board of directors to reflect the stock's fair market value as appraised by outside consultants. Following the Stock Transaction, BBC USA and its subsidiaries that own Taxpayer filed forms with the Internal Revenue Service for S corporation election and S corporation qualified election, and the reorganization was complete.

In addition to removing one level of federal income taxation, the reorganization had the effect of permitting the holding company and its subsidiaries to remain privately-held companies. This allowed BBC USA and its subsidiaries to avoid "the expense and inconvenience of registering its securities and publicly reporting its financial results," according to BBC USA's "Second Amended and Restated Plan of Reorganization." The production, distribution, and sale of Blue Bell ice cream remained unaffected by the reorganization, and the reorganization achieved its goal of reducing the expenses associated with federal taxation and federal reporting regulations.

Taxpayer reported capital gains of $119,909,317 on its 2001 federal income tax return. These capital gains were realized from the Stock Transaction in which Taxpayer received $142,506,000 from BBC USA's redemption of 1,131 shares of stock. Because Taxpayer is a pass-through entity, Taxpayer's partners incurred federal income tax liability for the capital gains that Taxpayer reported. Taxpayer thereafter distributed $94,106,645 of the $142,506,000 to its partners for payment of the taxes attributable to the capital gains.

On its Tennessee excise tax return, Taxpayer classified the $119,909,317 in capital gains as non-business earnings not subject to Tennessee's excise tax. The Department conducted an audit of Taxpayer. The Department classified the capital gains of $119,909,317 as business earnings subject to Tennessee's excise tax. The Department assessed Taxpayer $146,025.25 for its tax liability for the 2001, 2002, and 2003 tax years. Of the tax liability, the Department states that $120,676.61 was related to the capital gains from the Stock Transaction. Taxpayer made a payment in the amount of $146,025.25 and filed a complaint in chancery court seeking a refund of $128,407,[3] interest on any refund pursuant to Tennessee Code Annotated section 67-1-1803(b) (2006), and attorney's fees pursuant to Tennessee Code Annotated section 67-1-1803(d).

Both parties filed motions for summary judgment. The chancery court granted Taxpayer's motion for

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[3] Taxpayer stated that $128,407 is "the amount of all excise tax, interest, and penalties assessed by Defendant against and paid by [Taxpayer]" on the capital gains.

summary judgment and denied the Department's motion for summary judgment. The chancery court awarded Taxpayer a refund in the amount of $164,779.07 "as well as statutory interest continuing to accrue on the tax principal of $121,309.74 from December 1, 2008, until the refund is paid." The chancery court awarded attorney's fees and expenses but reserved judgment as to these amounts until the adjudication of all appeals. The Court of Appeals affirmed the chancery court's judgment. We granted permission to appeal.

II. Analysis

The granting or denying of summary judgment is a matter of law, and we therefore review the trial court's grant of summary judgment to Taxpayer de novo. Blair v. W. Town Mall, 130 S.W.3d 761, 763 (Tenn. 2004). The party moving for summary judgment has the burden of introducing or identifying admissible facts in the record showing that there is no genuine issue of material fact and that it is entitled to judgment as a matter of law. Mills v. CSX Transp., Inc., 300 S.W.3d 627, 631 (Tenn. 2009); see Tenn. R. Civ. P. 56.04. Neither element of summary judgment is waived merely because both parties have moved for summary judgment. Each party moving for summary judgment has the burden of demonstrating that there is no genuine issue of material fact and that it is entitled to judgment as a matter of law. See CAO Holdings, Inc. v. Trost, No. M2008-01679-SC-R11-CV, ___ S.W.3d ___, 2010 WL 5111414, at *7 (Tenn. Dec. 15, 2010).

Taxpayer and the Department both filed motions for summary judgment. Each party filed a different statement of undisputed, material facts, and neither

party contested any fact in the opposing statement.[4] After carefully reviewing the record, we hold that there is no genuine issue of material fact. Our analysis therefore is limited to whether either party is entitled to judgment as a matter of law.

Taxpayer asserts that the undisputed facts in the record show that the Department impermissibly classified the capital gains from the single Stock Transaction as business earnings contrary to Tennessee Code Annotated section 67-4-2004(1) (Supp. 2000) (current version at Tenn. Code Ann. § 67-4-2004(4) (Supp. 2010)). Taxpayer further asserts that the Department's excise tax assessment on the capital gains that Taxpayer realized from the Stock Transaction during the reorganization violated the United States Constitution. The Department asserts that the uncontested facts show that the tax assessment was valid pursuant to Tennessee Code Annotated section 67-4-2004(1) and the United States Constitution.

The determination of whether a tax assessment is contrary to statute or is unconstitutional requires an application of law to the facts. See Newell Window Furnishing, Inc. v. Johnson, 311 S.W.3d 441, 443-44 (Tenn. Ct. App. 2008); Louis Dreyfus Corp. v. Huddleston, 933 S.W.2d 460, 469 (Tenn. Ct. App. 1996). If the determination requires conclusions of law without any conclusions of fact, the matter is ripe for disposition by summary judgment. See Green v. Green,

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[4] The Department challenged Taxpayer's statements that included legal conclusions but did not contest any of Taxpayer's factual assertions.

293 S.W.3d 493, 513 (Tenn. 2009). We first address whether the Department's tax on the capital gains from the Stock Transaction was contrary to statute before addressing whether the Department's tax on the capital gains was unconstitutional.

A. Validity of Excise Tax Assessment

Taxpayer contends that the Department's excise tax on its capital gains from the Stock Transaction impermissibly classified the capital gains as business earnings contrary to Tennessee Code Annotated section 67-4-2004(1). Tennessee's excise tax on corporate earnings is based on the Uniform Division of Income for Tax Purposes Act ("UDITPA"), a model law drafted by the National Conference of Commissioners on Uniform State Laws. Gen. Care Corp. v. Olsen, 705 S.W.2d 642, 644 (Tenn. 1986). The excise tax is assessed to "net earnings," which are broadly defined as the income that the entity reports to the federal government. Tenn. Code Ann. §§ 67-4-2005 to -2007 (Supp. 2000). To determine the excise tax due from an entity that conducts business activities that are taxable both inside and outside of Tennessee, the taxpayer must "allocate or apportion its net earnings." Tenn. Code Ann. § 67-4-2010 (Supp. 2000). Tennessee Code Annotated section 67-4-2011 (Supp. 2000) provides the manner in which a taxpayer allocates its earnings, and Tennessee Code Annotated section 67-4-2012 (Supp. 2000) provides the formula by which a taxpayer apportions its net earnings to determine its excise tax.

The apportionment formula uses a ratio based on Tennessee's portion of the taxpayer's property, payroll, and sales and is thus deemed to represent the entity's

earnings that are derived from Tennessee. Gen. Care Corp., 705 S.W.2d at 644. Apportionment is designed "to obtain a rough approximation of the corporate income that is reasonably related to the activities conducted within the taxing State." Exxon Corp. v. Wisc. Dep't of Revenue, 447 U.S. 207, 223 (1980) (internal quotations omitted); accord Gen. Care Corp., 705 S.W.2d at 644. The apportionment formula is applied to an entity's "business earnings," which are defined as "earnings arising from transactions and activity in the regular course of the taxpayer's trade or business or earnings from tangible and intangible property if the acquisition, use, management or disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations." Tenn. Code Ann. § 67-4-2004(1). The apportionment formula is not applied to"non-business earnings," which are defined as "all earnings other than business earnings." Tenn. Code Ann. § 67-4-2004(14). Non-business earnings instead are allocated for tax purposes to the state in which the non-business earnings originated.

Taxpayer specifically argues that its capital gains from the Stock Transaction were non-business earnings that are not subject to the excise tax. We determine whether earnings are business earnings and therefore apportionable when calculating the excise tax using either the transactional test or the functional test. Newell Window Furnishing, Inc., 311 S.W.3d at 446-47 (citing Assoc. P'ship I, Inc. v. Huddleston, 889 S.W.2d 190, 195-96 (Tenn. 1994)). Both tests are derived from the statutory definition of business earnings. The transactional test classifies earnings "arising from transactions and activity in the regular course of the taxpayer's trade or business" as business

earnings. Tenn. Code Ann. § 67-4-2004(1); Assoc. P'ship I., Inc., 889 S.W.2d at 195. The functional test classifies "earnings from tangible and intangible property" as business earnings "if the acquisition, use, management or disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations." Tenn. Code Ann. § 67-4-2004(1).

The earnings at issue in this appeal were from a one-time, extraordinary transaction. Specifically, the capital gains arose from Taxpayer's acquisition and sale of 1,131 shares of stock. The capital gains do not qualify as business earnings pursuant to the transactional test because the earnings did not arise from transactions or activity in the regular course of Taxpayer's ice cream business. The Department therefore is entitled to judgment as a matter of law as to this issue only if the uncontested facts show that the capital gains qualify as business earnings pursuant to the functional test.

In 1993, the General Assembly amended the definition of "business earnings" to explicitly include the functional test. 1993 Tenn. Pub. Acts 282 (current version at Tenn. Code Ann. § 67-4-2004(4)); see Assoc. P'ship I, Inc., 889 S.W.2d at 195 n.3. The Court of Appeals applied the functional test in Newell Window Furnishing, Inc., 311 S.W.3d at 447. The intermediate appellate court clarified that the determinative issue of the functional test is not whether the disposition of the property is an integral part of the taxpayer's regular trade or business operations but whether the property being disposed of constitutes an integral part of the taxpayer's regular business. Id. The tax at issue in Newell Window Furnishing, Inc. was assessed on earnings from the sale of one hundred percent of a

corporation's capital stock, which was deemed a sale of assets for the purpose of federal taxation. 311 S.W.3d at 445 (citing 26 U.S.C. § 338(h)(10)). It was uncontested by the parties that the property at issue was integral to the taxpayer's regular business. Id. The Court of Appeals therefore held that the gain realized from the sale of the stock was business earnings pursuant to the functional test. Id.

Unlike the parties in Newell Window Furnishing, Inc., the Department and Taxpayer disagree as to whether the 1,131 shares of stock constituted an integral part of Taxpayer's ice cream business. Neither this Court nor the Court of Appeals has addressed how courts may determine whether property constitutes an integral part of the taxpayer's regular trade or business operations for the purpose of the functional test. Because the functional test is derived from the statutory definition of business earnings, our role is to ascertain and give full effect to the legislative intent in adopting the functional test. See State v. Marshall, 319 S.W.3d 558, 561 (Tenn. 2010). When the statute's language is unambiguous, we find the legislative intent in the plain and ordinary meaning of the language. Id.

The meaning of the phrase "property constitut[ing] an integral part of the taxpayer's regular trade or business operations" depends on the meaning of "integral," which has multiple definitions. Integral may be defined as "of, relating to, or serving to form a whole," as "essential to completeness," or as "organically joined or linked." Webster's Third New Int'l Dictionary 1173 (1993). These meanings are not interchangeable, and the precise meaning of the

language "an integral part of the taxpayer's trade or business operations" is uncertain.

The statutory definition of "business earnings" in Tennessee Code Annotated section 67-4-2004(1) also provides, however, that "[t]his subdivision expresses the legislative intent to implement and clarify the distinctions between business and nonbusiness earnings, as found in the Uniform Division of Income for Tax Purposes Act, as generally interpreted by states adopting the act." Accordingly, we look for guidance to other jurisdictions that have adopted the UDITPA in applying the functional test. See Holiday Inns, Inc. v. Olsen, 692 S.W.2d 850, 853 (Tenn. 1985).

Courts are not uniform in their application of the functional test. See Walter Hellerstein, The Business-Nonbusiness Income Distinction and the Case for its Abolition, 92 Tax Notes 1701, 1714 (2001). Moreover, a court's application of the functional test may depend on the nature of the property being considered. Cf. McKesson Water Prods. Co. v. Dir., Div. of Taxation, 23 N.J. Tax 449, 457-62 (N.J. Tax Ct. 2007) (surveying applications of the functional test in cases in which the taxpayer is deemed to have sold all of its assets and distinguishing an opinion that relied on a case involving a transfer of funds from a pension plan). The matter before us concerns Taxpayer's capital gains from its acquisition and sale of stock rather than gains from the acquisition and sale of tangible assets. We therefore consider opinions from jurisdictions applying the functional test to earnings derived from investments.

Two state supreme courts have considered whether earnings obtained from investments in overfunded

pension plans[5] are business earnings pursuant to the functional test. In Union Carbide Corp. v. Offerman, the North Carolina Supreme Court held that earnings obtained by a taxpayer from its overfunded pension plan constituted nonbusiness earnings. 526 S.E.2d 167, 171 (N.C. 2000). The court held that for earnings from property to qualify as business earnings, there must be some indicia of the taxpayer's ownership of the property and the property must be "essential to completeness" of the taxpayer's regular trade or business. Id. The earnings from the overfunded pension plan did not satisfy these factors. The taxpayer, Union Carbide, merely "was the plan's sponsor, not its owner." Id. at 170. Additionally, the assets from the pension plan were not essential to Union Carbide's regular business of producing and selling alloys and chemicals. Id. at 171. The court further observed that "the assets [from] the pension plan were not used to generate income in the regular business operations." Id. The assets were not used as working capital or for collateral. Id. The assets were not actively traded, used to purchase equipment, or used to support research and development. Id. The

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[5] Federal income tax laws permit employers to establish qualified pension plans for employees in which employee contributions to the plan are not immediately taxable but employer contributions to the plan are immediately deductible as ordinary and necessary business expenses. A pension trust, not the employer, typically manages, invests, and distributes the employer's and employees' contributions as well as the earnings the contributions generate. If the assets in the pension plan exceed the amount the plan needs for future pension liability, the employer is entitled to receive the pension's excess assets. These earnings constitute ordinary income for federal tax purposes. Hellerstein, The Business-Nonbusiness Income Distinction and the Case for its Abolition, 92 Tax Notes 1701, 1710-11.

assets therefore failed to constitute business earnings pursuant to the functional test as adopted by the North Carolina Supreme Court.

The California Supreme Court applied the functional test differently when considering whether assets from an overfunded pension plan were business earnings in Hoechst Celanese Corp. v. Franchise Tax Bd., 22 P.3d 324, 343 (Cal. 2001). The court first determined that the functional test does not require "legal ownership or title to the property" for earnings from the property to be business earnings. Id. at 338. Instead, the language "acquisition, management, and disposition of the property" requires the taxpayer to "(1) obtain some interest in and control over the property; (2) control or direct the use of the property; and (3) transfer, or have the power to transfer, control of that property in some manner." Id.

The California Supreme Court next considered the plain meaning of the language in the functional test and determined that "integral" has multiple definitions. Id. at 339. Looking to the history of the distinction between business and nonbusiness earnings in the UDITPA, the California Supreme Court concluded that property is integral to the taxpayer's regular trade or business if "the taxpayer's control and use of the property . . . contribute materially to the taxpayer's production of business income so that the property becomes interwoven into and inseparable from the taxpayer's business." Id. at 338-39. This definition of business earnings, the court observed, encompasses less than all the property that contributes to the business and thus avoids constitutional concerns. Id. at 339-40. It encompasses, however, more than property that is "necessary or

essential to" the taxpayer's regular business and therefore includes gains from the sale of property no longer used in the taxpayer's trade or business, a scenario contemplated in the explanatory comments to the UDITPA. Id. at 340 (citing UDITPA, cmt. following § 1(a) (West, current through 2009), *available at* http://www.law.upenn.edu/bll/archives/ulc/fnact99/1920_69/udiftp57.pdf (last visited Jan. 5, 2011)).

Using its construction of the functional test, the California Supreme Court determined that earnings from the overfunded pension plan were business earnings. The court observed that the taxpayer, Hoechst Celanese, exercised control over the plan and used the plan to retain current employees and to attract new employees. Id. at 343. Hoechst Celanese's management of the plan contributed materially to its business earnings "by improving the efficiency and quality of its workforce" generating the business earnings. Id.

After careful review, we adopt the functional test promulgated by the California Supreme Court. We agree that the language "acquisition, use, management or disposition of the property" in the definition of business earnings suggests that the taxpayer must control, but not necessarily own, the property for earnings arising from that property to qualify as business earnings. Tenn. Code Ann. § 67-4-2004(1). We also agree with the California Supreme Court that property must contribute materially to the production of business income to constitute an integral part of taxpayer's regular trade or business operations. Hoechst Celanese Corp., 22 P.3d at 338-39. This approach appropriately includes earnings from property that allows the taxpayer's business

operations to prosper while excluding earnings from property that is incidental or unrelated to the taxpayer's business operations. We therefore hold that earnings from a taxpayer's property constitute business earnings pursuant to the functional test if the taxpayer's control of the property contributes materially to taxpayer's production of business earnings.

Turning to the issue before us, the Department assessed the excise tax to Taxpayer's capital gains from its acquisition and sale of 1,131 shares of BBC USA stock. Taxpayer's acquisition and sale of the stock was a necessary step in the reorganization of the business entities that profit from the production, sale, and distribution of Blue Bell ice cream. The Stock Transaction did not affect Taxpayer's production, sale, and distribution of Blue Bell ice cream. Taxpayer's acquisition and sale of the stock, however, reduced expenses that detracted from the earnings arising from the sale of Blue Bell ice cream in Tennessee and elsewhere. This result was accomplished because the Stock Transaction completed the reorganization that allowed the business entitles profiting from the sale of Blue Bell ice cream to avoid costly public reporting requirements. The Stock Transaction and reorganization also removed one level of federal taxation on the earnings arising from the Blue Bell ice cream business. We hold that Taxpayer's acquisition and sale of the stock therefore contributed materially to the production of business earnings arising from the sale of Blue Bell ice cream and that Taxpayer's capital gains thus qualify as business earnings pursuant to the functional test. The Department has identified uncontested facts showing that it is entitled to judgment as a matter of law as to this issue.

B. Constitutionality of Tax Assessment

Taxpayer contends, in the alternative, that the Department's tax was unconstitutional. The Due Process Clause of the Fourteenth Amendment to the United States Constitution imposes two requirements on a state's taxing power over a multistate business enterprise. Exxon Corp., 447 U.S. at 219-20. First, the taxing state must have some minimum connection with the business entity it seeks to tax. Allied-Signal, Inc. v. Dir., Div. of Taxation, 504 U.S. 768, 777 (1992) (quoting Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-45 (1954)). Taxpayer conducts business in Tennessee. The Department therefore may tax Taxpayer.

The second requirement of the Due Process Clause is that there must be a rational relationship between the income attributed to the taxing state and the intrastate value of the business being taxed. Allied-Signal. Inc., 504 U.S. at 772. A state may not tax income from an activity or property to which the state does not have a connection, even if the state has a minimum connection to the actor or owner. Id. at 778 (stating that "in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor"). The Commerce Clause imposes a "parallel" limitation that forbids states from levying taxes that discriminate against or burden interstate commerce "by subjecting activities to multiple or unfairly apportioned taxation." MeadWestvaco Corp. v. Ill. Dep't of Revenue, 553 U.S. 16, 24 (2008). These constitutional limitations prohibit states from taxing value that is generated without any "protection, opportunities and benefits" from the taxing state. Id. at 24-25 (stating that the "broad

inquiry" is "'whether the state has given anything for which it can ask return'" (quoting ASARCO Inc. v. Idaho Tax Comm'n, 458 U.S. 307, 315 (1982))).

Because the income of a multistate business enterprise like Taxpayer may be generated from a myriad of assets and activities across state lines, the United States Supreme Court has set forth guidance to assist taxing states in complying with the Due Process and Commerce Clauses. The United States Supreme Court has recognized that the value of a multistate business enterprise often cannot be fairly apportioned based solely on the business's activities or property within the borders of the taxing state. See MeadWestvaco Corp., 553 U.S. at 26. Accordingly, the United States Supreme Court permits states to tax an apportionable share of a multistate business enterprise rather than taxing only that part of the multistate business enterprise that is within the taxing state. Allied-Signal. Inc., 504 U.S. at 778. To ensure that a taxing state taxes its fair share of the value of a multistate business enterprise within the limitations imposed by the Due Process and Commerce Clauses, the United States Supreme Court adopted the unitary business principle. See id.

The unitary business principle provides that a state may tax an apportioned share of the income from a multistate business enterprise's unitary business if the unitary business is conducted in part in the taxing state. See MeadWestvaco Corp., 553 U.S. at 25. The operation of the unitary business in the taxing state creates a sufficient nexus between the taxing state and the unitary business's out-of-state activities or assets to satisfy Due Process and Commerce Clause concerns.

Taxpayer operates the Blue Bell ice cream business in Tennessee. Pursuant to the unitary business principle, the Department therefore may constitutionally tax Tennessee's fair portion of the Blue Bell ice cream business, including any income from out-of-state activities, assets, or business entities that are unitary with the ice cream business in Tennessee. The income at issue in Taxpayer's challenge is Taxpayer's capital gains from its acquisition and sale of stock during the reorganization. We must determine, therefore, whether the Stock Transaction and reorganization are unitary with Taxpayer's ice cream business.

The United States Supreme Court has used the "operational-function" concept to determine whether income derived from assets such as stock is part of the Taxpayer's unitary business. Allied-Signal. Inc., 504 U.S. at 787; accord MeadWestvaco Corp., 553 U.S. at 29 ("'The concept of operational function simply recognizes that an asset can be part of a taxpayer's unitary business even if what we may term a 'unitary relationship' does not exist between the 'payor and payee.'"); see Walter Hellerstein, MeadWestvaco and the Scope of the Unitary Business Principle, 108 J. Tax'n 261, 263 (May 2008) ("[T]he Court explicitly embraced the 'operational-function' concept as a basis for apportionability of income from *assets*." (emphasis in original)). The United States Supreme Court has held that income from a capital transaction such as the Stock Transaction and the reorganization is part of a taxpayer's unitary business if the capital transaction serves an operational function rather than an investment function. Allied-Signal. Inc., 504 U.S. at 787. An asset serves an operational function if the asset helps the taxpayer make better use of the

taxpayer's existing business-related resources. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 178 (1983). The United States Supreme Court has stated that an investment function serves to diversify the entity and reduce the risks associated with "being tied to one industry's business cycle." Id. For the Department to be entitled to judgment as a matter of law as to this constitutional issue, therefore, the uncontested facts must show that the Stock Transaction and reorganization served an operational function.

Applying the United States Supreme Court's distinction between operational and investment functions to the present case, we hold that the Stock Transaction served an operational function rather than an investment function for the Blue Bell ice cream business. Taxpayer acquired and sold the 1,131 shares of stock solely as part of the reorganization of the entities profiting from the business. The Stock Transaction neither diversified the business nor reduced risks associated with the ice cream business. To the contrary, the Stock Transaction and reorganization served to increase net gain from the ice cream business. Because the capital transaction served an operational function for Taxpayer's business, Taxpayer's income from the stock is unitary with Taxpayer's ice cream business.

Taxpayer contends, however, that the Stock Transaction and reorganization were BBC USA's activities. In support, it points to the uncontested fact that BBC USA implemented and controlled the reorganization, including the Stock Transaction. Although the reorganization resulted in Taxpayer's formation, Taxpayer states that it was a passive

participant in the reorganization and Stock Transaction. Taxpayer further asserts that BBC USA is not unitary with Taxpayer's ice cream business in Tennessee.

The operational-function concept is limited to determining when earnings from assets are part of the taxpayer's unitary business. Assuming *arguendo* that the Stock Transaction and reorganization were exclusively BBC USA's activities, the United States Constitution would prohibit the Department from taxing Taxpayer for capital gains from the Stock Transaction unless it first determined that BBC USA was unitary with Taxpayer's ice cream business. See MeadWestvaco Corp., 553 U.S. at 29-30. We therefore consider whether BBC USA and Taxpayer are unitary pursuant to the unitary business principle.

It is uncontested that BBC USA is a separate business entity from Taxpayer. To determine whether two separate business entities form a unitary business, we must look beyond the superficial divisions between parent corporations and their subsidiaries to the "underlying activity" generating the income. See Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 440-41 (1980). To be an unrelated business activity, the separate business entity must constitute a "discrete business enterprise" from the taxpayer. Exxon Corp., 447 U.S. at 223-24.

For Taxpayer and BBC USA, the only underlying activity generating income is the production, sale, and distribution of Blue Bell ice cream. BBC USA may be a separate business entity, but it is uncontested that BBC USA does not conduct any business operations of its own. Furthermore, BBC USA exists as a separate

business entity to channel income from Taxpayer to BBC USA's stockholders without incurring a Texas franchise tax, according to William Rankin, the Chief Financial Officer of Taxpayer's general partner. Mr. Rankin also characterized BBC USA and BBC USA's subsidiaries as part of the singular ice cream business and characterized the stockholders of BBC USA as investors in the ice cream business. Because both entities derive their income from a single underlying activity, we hold that BBC USA is unitary with Taxpayer's Blue Bell ice cream business.

Taxpayer contends, however, that it and BBC USA are not unitary pursuant to the tests that the United States Supreme Court has described for determining whether two businesses are unitary. Following the "hallmarks of a unitary relationship" test, for example, two separate business entities form a unitary business if their business operations are functionally integrated, have centralized management, and obtain economies of scale from their relationship. MeadWestvaco Corp., 553 U.S. at 30. The "three unities" test similarly provides that two separate business entities form a unitary business if there is "(1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use of its centralized executive force and general system of operation." Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298, 304 n.1 (1994) (quoting Butler Bros. v. McColgan, 111 P.2d 334, 341 (Cal. 1941), aff'd, 315 U.S. 501 (1942) (internal quotation marks omitted)). Finally, two separate business entities are unitary pursuant to the "dependency and contribution" test used by other states if the taxpayer's business operations in the taxing state are dependent on or contribute to the

operation of the separate business entity outside the state. In re Nat'l Coop. Refinery Ass'n, 44 P.3d 398, 404 (Kan. 2002); see generally Louis Dreyfus Corp., 933 S.W.2d at 468 (citing courts that have used the dependency and contribution test).

These tests are ill-suited for assessing Taxpayer and BBC USA's relationship because all three tests require a comparison of the relationship of the separate business entities' business operations. Taxpayer admits that BBC USA "does not conduct any business operations." BBC USA therefore has no business operations that we can compare to Taxpayer's business operations.

Furthermore, the United States Supreme Court has placed the burden on the taxpayer challenging the tax assessment to demonstrate that the tax is unconstitutional. Butler Bros. v. McColgan, 315 U.S. 501, 507 (1942). Regardless of the analysis we use, it is Taxpayer's burden to identify clear and cogent evidence demonstrating that Taxpayer and BBC USA are discrete business enterprises. See Exxon Corp., 447 U.S. at 221; Mobil Oil Corp., 445 U.S. at 453-54. Our review of the record reveals no clear and cogent evidence showing that BBC USA operates a business enterprise that is discrete from that of Taxpayer. We therefore consider Taxpayer and BBC USA unitary. See Mobil Oil Corp., 445 U.S. at 439-40. Because the uncontested facts show that the Department's tax was constitutional, the Department is entitled to judgment as a matter of law.

We cannot determine from the record, however, whether Taxpayer is nevertheless entitled to a refund for any overpayment of taxes. The Department asserts

that Taxpayer's excise tax for the capital gains was $120,676.61, relying on an affidavit by an auditor at the Department. Taxpayer, however, sought a refund of $128,407, which Taxpayer described as the amount of all excise tax, interest, and penalties paid by Taxpayer for the excise tax assessment on the capital gains. We therefore remand this matter to the trial court to determine the amount of excise tax related to the Stock Transaction.

III. Conclusion

We conclude that the Department's assessment of excise tax on Taxpayer's capital gains from the January 1, 2001 Stock Transaction and reorganization was permissible pursuant to Tennessee Code Annotated section 67-4-2004(1) and the United States Constitution. Because the uncontested facts show that the Department is entitled to judgment as a matter of law, the trial court erred in granting Taxpayer's motion for summary judgment and in denying the Department's motion for summary judgment. We reverse the judgment of the Court of Appeals affirming the trial court's order and grant the Department summary judgment. We remand to the trial court to determine the amount of excise tax related to Taxpayer's capital gains and for further proceedings consistent with this opinion. Costs of this appeal are assessed against the appellee, Blue Bell Creameries, LP, for which execution may issue if necessary.

/s/ Janice M. Holder
JANICE M. HOLDER, JUSTICE

IN THE SUPREME COURT OF TENNESSEE
AT NASHVILLE
June 3, 2010 Session

No. M2009-00255-SC-R11-CV

[Filed January 24, 2011]

BLUE BELL CREAMERIES, LP	)
	)
v.	)
	)
RICHARD ROBERTS, COMMISSIONER, DEPARTMENT OF REVENUE, STATE OF TENNESSEE	)

Chancery Court for Davidson County
No. 06-414-III Ellen H. Lyle, Chancellor

JUDGMENT

This cause came on to be heard upon the record on appeal from the Court of Appeals, briefs and argument of counsel; and upon consideration thereof, this Court is of the opinion that Taxpayer's capital gains were business earnings pursuant to the functional test provided in Tennessee Code Annotated section 67-4-2004(1) and therefore subject to the excise tax. Additionally, we hold that the tax assessment was constitutional pursuant to the unitary business principle.

In accordance with the opinion filed herein, it is, therefore, ORDERED AND ADJUDGED by this Court that the judgment of the Court of Appeals affirming

the chancery court's grant of summary judgment be and the same is hereby reversed.

The costs of this appeal are taxed to the Blue Bell Creameries, LP, for which execution may issue if necessary.

APPENDIX B

IN THE COURT OF APPEALS OF TENNESSEE
AT NASHVILLE
July 9, 2009 Session

No. M2009-00255-COA-R3-CV

[Filed September 29, 2009]

BLUE BELL CREAMERIES, L.P.	)
	)
v.	)
	)
LOREN CHUMLEY, COMMISSIONER DEPARTMENT OF REVENUE, STATE OF TENNESSEE	)
	)

Appeal from the Chancery Court
for Davidson County
No. 06-414-III Ellen Hobbs Lyle, Chancellor

The Tennessee Department of Revenue assessed an excise tax on a nondomiciliary subsidiary corporation which conducted business in the state based on income earned outside the state as a result of the parent corporation's redemption of outstanding stock held by the subsidiary. The Department's tax assessment was based on a determination that the income was taxable as "business earnings" under the Tennessee Excise Tax Law. The trial court found that the subsidiary and its parent corporation were not part of a unitary

business relationship and, consequently, that the tax assessment was unconstitutional. Finding that the entities were not part of a unitary business relationship, the judgment of the trial court is affirmed.

Tenn. R. App. P. 3 Appeal as of Right; Judgment of the Chancery Court Affirmed

RICHARD H. DINKINS, J., delivered the opinion of the court, in which ROBERT W. WEDEMEYER, J., joined. PATRICIA J. COTTRELL, P.J., M.S., not participating.

Robert E. Cooper, Jr., Attorney General and Reporter, Michael E. Moore, Solicitor General, and Brad H. Buchanan, Assistant Attorney General, for the appellant, the Commissioner of the Tennessee Department of Revenue.

James C. Bradshaw, III, Nashville, Tennessee, for the appellee, Blue Bell Creameries, L.P.

OPINION

In this case, we are called upon to determine whether the capital gain realized by a subsidiary entity as a result of a parent corporation's redemption of outstanding stock held by the subsidiary entity was subject to Tennessee's excise tax. We hold that the subsidiary and the parent corporation were not part of a unitary business relationship and, consequently, the tax assessment was unconstitutional.

I. Background

Taxpayer, a limited partnership domiciled in Texas, was formed in November 2000 by Blue Bell Creameries, USA ("BBC USA") as part of a corporate reorganization. Prior to the reorganization, Taxpayer's predecessor, a limited partnership in which Blue Bell Creameries, Inc. was general partner with a 1% interest and BBC Limited Partner, Inc. was limited partner with a 99% interest, was engaged in the business of producing, selling and distributing ice cream in multiple jurisdictions (the "Business"), including Tennessee. BBC USA was a Delaware corporation serving as a holding company and parent corporation of Taxpayer's predecessor; BBC USA indirectly owned 100% of Blue Bell Creameries, Inc., and directly owned 100% of BBC Limited Partner, Inc.

In November of 2000, BBC USA formed Taxpayer for the purpose of assuming the Business operated by its predecessor.[1] BBC USA's wholly owned subsidiaries and Taxpayer's predecessor contributed their assets to Taxpayer, after which Taxpayer's predecessor was liquidated into BBC Limited Partner, Inc. In addition, Blue Bell General Partner, Inc., was formed to be a general partner of Taxpayer.

As part of the reorganization, BBC USA became an "S corporation," thereby permitting 75 of its shareholders to exchange their BBC USA shares for an

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[1] When it was formed, Taxpayer was named Blue Bell Operating, L.P. After reorganization, Taxpayer's name was changed to its current name, Blue Bell Creameries, L.P., the same name held by its predecessor.

equal number of shares in the S corporation.[2] Certain eligible BBC USA shareholders not receiving shares in the S corporation were afforded the opportunity to contribute their BBC USA shares to Taxpayer in exchange for a limited partnership interest in Taxpayer.[3] Lastly, BBC USA's remaining shareholders, who did not receive shares in the S corporation or a limited partnership interest in Taxpayer, had their shares recapitalized, which converted their stock into a right to receive a lump sum cash payment.[4]

On January 1, 2001, the majority of BBC USA's shareholders contributed their BBC USA stock to Taxpayer in exchange for a limited partnership interest in Taxpayer. The same day, BBC USA redeemed the stock which had been contributed to Taxpayer in exchange for a cash payment of

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[2] Subchapter S of the Internal Revenue Code permits eligible small business corporations to elect to be organized as an "S corporation" for the purpose of seeking the preferential tax treatment established for such entities under the subchapter. *See generally* 26 U.S.C. § 1361, *et. seq.* At the time of the reorganization, an S corporation was statutorily limited to no more than 75 shareholders. 26 U.S.C. § 1361 (2001). The current statute, effective May 25, 2007, allows an S corporation to have no more than 100 shareholders. 26 U.S.C. § 1361 (2007).

[3] The record does not show what the eligibility criteria were.

[4] According to BBC USA's Second Amended and Restated Plan of Reorganization, the "Recapitalization" resulted in "each Ineligible Stockholder [receiving] an amount . . . equal to $195,000 for its shares."

$142,506,000.00; this redemption resulted in a capital gain of $119,909,317.00 to Taxpayer.[5]

In its 2001 Tennessee Franchise and Excise Tax Return, Taxpayer classified the capital gain realized from the January 1 stock redemption as "nonbusiness earnings." At some point, the Tennessee Department of Revenue ("Department") determined that the capital gain was a "business earning" and that it should have been included in Taxpayer's apportionable income subject to the State's excise tax. Taxpayer filed an objection with the Department, which was denied on May 20, 2005. On August 31, 2005, Taxpayer paid the Department $146,025.25, which accounted for unpaid amounts owed, plus interest and penalties, as of August of 2005.[6]

On February 14, 2006, Taxpayer filed suit against the Department, seeking a 'refund of $128,407.00 for "all excise tax, interest, and penalties assessed by [the Department] . . . on the gain realized by [Taxpayer] in the redemption by BBC USA of its shares" and for

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[5] After reorganization, the corporate structure included BBC USA, now an S corporation, as parent of the various entities; Blue Bell Creameries, Inc., formerly general partner of Taxpayer's predecessor, whose role after the reorganization is not apparent in the record; BBC Limited Partner, Inc., limited partner of Taxpayer; Blue Bell General Partner, Inc., general partner of Taxpayer; and Taxpayer.

[6] Taxpayer's $146,025.26 payment to the Department included amounts not related to this matter and constituted an overpayment in the amount of $48.63, which was applied to its future tax years.

"interest on any refund awarded."[7] The Department filed an answer on March 20, 2006. Both parties subsequently filed motions for summary judgment and a hearing on the motions was held on August 1, 2008.

On August 15, 2008, the trial court issued a "Memorandum and Order," which discussed both parties' reliance on the "unitary business principle" to "analyze the connection between [Taxpayer's] capital gains from the stock redemption and the business it regularly does in Tennessee." The order directed the Department to file a supplemental brief to clarify the "functional integration" between Taxpayer and BBC USA and to explain "the concrete tax advantages and non-reporting and non-registering of securities advantages [Taxpayer] received from the stock redemption and where in the record these advantages are proven." Taxpayer was given the opportunity to file a brief in reply.

On November 13, 2008, the trial court issued a Memorandum finding that the Department's tax imposition was unconstitutional and that there were insufficient facts in the record to determine whether the capital gain was a "business earning." On January 5, 2009, the trial court entered its order awarding Taxpayer a refund of $164,779.07, as well as statutory interest; pursuant to Rule 54.02, Tenn. R. Civ. P., the

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[7] Pursuant to Tenn. Code Ann. § 61-1-1801, a taxpayer is required to file a refund claim with the Commissioner of Revenue before seeking a refund with the Chancery Court; the Commissioner, however, waived that requirement at Taxpayer's request, as allowed by Tenn. Code Ann. § 67-1-1802(c)(2).

trial court directed the entry of a final judgment.[8] The Department appeals, raising the following issues:

> 1. Whether the income at issue is constitutionally apportionable and thus taxable as business earnings, when there is a unitary relationship between the payee-taxpayer, Taxpayer, and its holding company, BBC USA, in that everything done by each entity was orchestrated together to further the single ice cream business of which both are a part.
>
> 2. Whether the Chancery Court erred in holding that the record was insufficient for the court to conclude, as a matter of law, that the income at issue in this case constitutes "business earnings" under Tenn. Code Ann. § 67-4-2004(a)(1) (2000 Supp.), when the record establishes that Taxpayer acquired, used, and disposed of the income-producing property in a restructuring that was integral to the regular unitary business of which the taxpayer was a part.

II. Standard of Review

The issues in the present matter were resolved in the trial court upon the parties' cross-motions for summary judgment. Neither party contends on appeal that genuine issues of material fact exist regarding the

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[8] Having determined that Taxpayer was the prevailing party and, thereby, entitled to an award of attorneys' fees and expenses pursuant to Tenn. Code Ann. § 67-1-1803(d), the court reserved judgment on the amount of fees pending the resolution of appeals.

trial court's first holding that the imposition of the excise tax was unconstitutional. Summary judgment is appropriate if no genuine issues of material fact exist, and the movant meets its burden of proving that it is entitled to a judgment as a matter of law. *See* Tenn. R. Civ. P. 56.03; *Martin v. Norfolk Southern Ry. Co.*, 271 S.W.3d 76, 84 (Tenn. 2008). Therefore, our review of whether, under the undisputed facts, the tax imposition was constitutional is a matter of law. We take the strongest view of the evidence in favor of the nonmoving party, allowing all reasonable inferences in its favor and discarding all countervailing evidence. *See Shadrick v. Coker*, 963 S.W.2d 726, 731 (Tenn. 1998)(citing *Byrd v. Hall*, 847 S.W.2d 208, 210-11 (Tenn. 1993)). Since our review concerns questions of law, we review the record *de novo* with no presumption of correctness. *See* Tenn. R. App. P. 13(d); *Bain v. Wells*, 936 S.W.2d 618, 622 (Tenn. 1997). However, "[t]ax assessments are presumed to be valid" and "a taxpayer who challenges a . . . tax assessment must show by clear and convincing evidence that the . . . application of the apportionment formula has caused extraterritorial value to be taxed." *Louis Dreyfus Corp. v. Huddleston*, 933 S.W.2d 460, 467 (Tenn. Ct. App. 1996).

III. Analysis

The tax assessment at issue in this matter involves the Department's application of the Tennessee excise tax to a portion of Taxpayer's income earned outside the state. In order for the Department to tax out-of-state income, the tax assessment must be constitutional, pursuant to the Due Process and Commerce Clauses of the United States Constitution, *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois*

Dept. of Revenue, 128 S.Ct. 1498, 1505 (U.S. 2008), and must seek to apportion income which constitutes "business earnings," pursuant to Tennessee's "Excise Tax Law." *See* Tenn. Code Ann. § 67-4-2001, *et. seq.*

A. Constitutionality of the Tax Assessment

In its motion for summary judgment, the Department asserted that its taxation of the capital gains realized by Taxpayer from the stock redemption was "constitutionally permissible under the standard of unitariness required by the Due Process and Commerce Clauses of the United States Constitution" because Taxpayer's acquisition, and BBC USA's subsequent redemption, of the BBC USA stock were both "undertaken as a part of the unitary Business of which both [Taxpayer] and [BBC USA] were a part."

In its response in opposition to the Department's motion, Taxpayer asserted that the Department could not "legally levy a tax against the income of a multi-state corporation . . . [unless] the income [had] a substantial nexus to the business activities carried out by the taxpayer in the taxing state" and that "an extraordinary, one-time stock redemption transaction carried out by a holding company in Texas simply lacks sufficient nexus with [Taxpayer's] production, sale, and distribution of ice cream in the state of Tennessee to justify imposition of a tax."

The Due Process and Commerce Clauses "impose distinct but parallel limitations on a State's power to tax out-of-state activities." *MeadWestvaco Corp.*, 128 S.Ct. at 1505. "The principle that a State may not tax value earned outside its borders rests on the fundamental requirement of both the Due Process and

Commerce Clauses that there be 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'" *Allied Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777 (1992) (quoting *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-45 (1954)). "[I]n the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax." *Id.* at 778.

"Where . . . there is no dispute that the taxpayer has done some business in the taxing State, the inquiry shifts from whether the State may tax to what it may tax." *MeadWestvaco Corp.*, 128 S.Ct. at 1505. To answer that question, the United States Supreme Court developed the "unitary business principle," *MeadWestvaco Corp.*, 128 S.Ct. at 1505, which is "at the heart of any formula to apportion corporate revenues for tax purposes." *Louis Dreyfus Corp.*, 933 S.W.2d at 466. "Under th[e] principle, a State need not 'isolate the intrastate income-producing activities from the rest of the business' but 'may tax an apportioned sum of the corporation's multistate business if the business is unitary.'" *MeadWestvaco Corp.*, 128 S.Ct. at 1505 (quoting *Allied-Signal*, 504 U.S. at 772). "A unitary business is a business whose components are too closely connected and necessary to each other to justify division or separate consideration as independent units." *Louis Dreyfus Corp.*, S.W.2d at 467. "'In order to exclude certain income from the apportionment formula, the company must prove that "the income was earned in the course of activities unrelated to [those carried out in the taxing] State."'" *Allied-Signal, Inc.*, 504 U.S. at 787 (quoting *Exxon Corp. v. Department of Revenue of Wis.*, 447 U.S. 207, 223 (1980), in turn quoting *Mobil Oil Corp. v. Comm'r*

of Taxes of Vt., 445 U.S. 425, 439 (1980)). "Thus, the pivotal question in cases such as this one is whether the business income sought to be included in the apportionable tax base derives from an unrelated business activity constituting a discrete business enterprise that is not part of the taxpayer's unitary business." *Louis Dreyfus Corp.*, 933 S.W.2d at 466; *MeadWestvaco Corp.*, 128 S.Ct. at 1505.

Neither party disputes the fact that Taxpayer conducted business in Tennessee, thereby justifying the state's ability to tax its earnings, *Newell Window Furnishing, Inc. v. Johnson*, 2008 WL 5169560, at *5 (Tenn. Ct. App. Dec. 9, 2008) (citing *Allied-Signal, Inc.*, 504 U.S. at 778) ("where . . . a taxpayer has done business in the State, taxation is justified by the 'protection, opportunities and benefits' the State has conferred on the taxpayer's activities within the State"), and shifting the inquiry to whether the Department was constitutionally permitted to impose a tax on the earnings at issue. *MeadWestvaco Corp.*, 128 S.Ct. at 1505.

"The courts have devised several tests for determining whether a business is unitary." *Louis Dreyfus Corp.*, 933 S.W.2d at 468. The Department asserted that Taxpayer and BBC USA were unitary under either the "hallmarks of a unitary relationship" test or the operational function test; the trial court applied both tests in its determination as to whether the Department's tax assessment of Taxpayer's capital gains was constitutional.

1. "Hallmarks of a Unitary Relationship" Test

The test that has been described as the "'hallmarks' of a unitary relationship" test focuses on the functional integration, centralization of management, and economies of scale between business components. *Allied-Signal*, 112 S.Ct. at 783; *MeadWestvaco Corp.*, 128 S.Ct. at 1508; *Louis Dreyfus Corp.*, 933 S.W.2d at 469-71. Under this test, the "factors that should be considered . . . are the extent of control and ownership that the various components of the business have over one another, the degree of functional integration or interrelationship/interdependence among the business's operations, and the economies of scale." *Newell*, 2008 WL 5169560, at *6. "No single factor is controlling under any of the tests" and a court must "examine these factors in combination to determine whether the business is unitary." *Louis Dreyfus Corp.*, 933 S.W.2d at 468. "[A] relevant question in the unitary business inquiry is whether 'contributions to income [of the subsidiaries] result[ed] from functional integration, centralization of management, and economies of scale." *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 179 (1983) (quoting *F. W. Woolworth Co. v. Taxation and Revenue Dept. of State of N.M.*, 458 U.S. 354, (1982)).

In support of its motion for summary judgment, the Department relied upon the parties' pleadings; its Statement of Undisputed Material Facts[9]; the

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[9] In its Statement of Undisputed Material Facts, the Department made certain assertions of fact, to which Taxpayer provided the following responses, in part pertinent:

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1. [BBC USA] prior to the transactions and events of November 2000 through January 1, 2001 (the "Reorganization"), was "a privately owned holding company which exist[ed] to own the assets and properties of the related businesses and legal entities that develop, make, sell and otherwise operate the business and products commonly known as 'Blue Bell Ice Cream' (hereinafter referred to collectively as the 'Business').
RESPONSE: Undisputed.
***
10. Upon its formation, [Taxpayer] offered certain [BBC USA] stockholders the opportunity to exchange all of their [BBC USA] shares for an equal numbers [sic] of shares in the limited partnership interest of [Taxpayer]; about 250 shareholders accepted the offer and contributed 1,131 shares in exchange for approximately 29% of [Taxpayer's] partnership interests.
RESPONSE: Undisputed.
11. [BBC USA] purchased those of its shares held by [Taxpayer] "in a transaction considered to be a redemption of the affected shares (the 'Redemption')." The sole purpose of this redemption was to effectuate the Reorganization of the Business.
RESPONSE: Undisputed.
12. The Redemption price totaled $142,506,000. It was determined by the [BBC USA] board of directors to reflect the stock's fair market value as appraised by outside consultants.
RESPONSE: Undisputed.
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17. The Redemption payment of $142,506,000 from [BBC USA] to [Taxpayer] resulted in total capital gains of $119,909,317, which was includable in [Taxpayer's] federal taxable income and which [Taxpayer] thus reported as taxable gains to the federal government
RESPONSE: Undisputed.
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19. [Taxpayer's] acquisition of [BBC USA] stock from certain [BBC USA] stockholders was integral to the execution of the Business's Second Amended and Restated

deposition of William J. Rankin, Blue Bell General Partner, Inc.'s Chief Financial Officer[10]; the affidavit

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Plan of Reorganization.
RESPONSE: Undisputed.
20. The actual operation of the Business's ice cream business was controlled, managed, and conducted by [Taxpayer's predecessor] prior to Reorganization and by [Taxpayer] afterward.
RESPONSE: Undisputed.
21. [BBC USA] "was a holding company that did not conduct any business operations."
RESPONSE: Undisputed.
22. The Second Amended and Restated Plan of Reorganization was formulated and adopted centrally on behalf of all the entities within the Business.
RESPONSE: Undisputed.

[10] Attached as Exhibit No. 5 to Mr. Rankin's deposition was the Second Amended and Restated Plan of Reorganization, which contained the following provisions, in part pertinent:

2. **Purpose of the Plan**. [BBC USA's] board of directors desires to reorganize [BBC USA] so that it can remain a private company of an indefinite period of time, thereby avoiding the expense and inconvenience of registering its securities and publicly reporting its financial results and so that its stockholders may receive "pass through" tax treatment after effecting the transactions contemplated in this Second Amended and Restated Plan of Reorganization (the "Plan") by qualifying [BBC USA] or its successor, as an S corporation, as defined in [Internal Revenue] Code section 1361.
3. **Overview of Plan of Reorganization**. Pursuant to the Plan of Reorganization:
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c. [Taxpayer] will offer certain eligible [BBC USA] stockholders the opportunity to exchange all their currently owned [BBC USA] Shares for an equal number of LP Shares (the "LP Offering").

of Terri McAllister, a tax auditor employed by the Department, which discussed Taxpayer's tax liability under both parties' positions; Taxpayer's responses to the Department's first set of interrogatories[11] and

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> ***
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> e. [BBC USA] will purchase the [BBC USA] Shares held by [Taxpayer] as a result of the LP Offering in a transaction considered to be a redemption of the affected shares (the "Redemption"). [BBC USA] will pay a Redemption price determined by the [BBC USA] board of directors to be equivalent to the fair market value of the [BBC USA] Shares based on the advice of an independent valuation expert . . . The Redemption will be a taxable event for Federal income tax purposes and will cause *participants in the LP Offering* to pay Federal income tax based on the gain *they recognize* from the Redemption.

(Emphasis added).

[11] Taxpayer provided the following responses, in part pertinent, to interrogatories filed by the Department:

> INTERROGATORY NO. 3: Identify and describe the business of the entity called [BBC USA] as of January 1, 2001, including all lines of business in which BBC USA was involved at the time, any and all subsidiaries of BBC USA at and around that time, and any ownership, contractual, organization, or other business relationship with [Taxpayer] at that time.
> ANSWER: At January 1, 2001, [BBC USA] was a holding company. BBC USA held, either directly or indirectly, a 100% interest in Blue Bell Creameries [], Inc. . . . and BBC Limited Partner, Inc., . . . which were holding companies. BBC USA also held an indirect 100% interest in Blue Bell Creameries, Inc., the General Partner of [Taxpayer]. BBC USA indirectly held an approximately 70% interest in [Taxpayer], the operating company that manufactures and distributes Blue Bell Ice Cream and other frozen dessert products.

document requests[12]; and Taxpayer's response to the Department's second set of interrogatories.[13]

***

INTERROGATORY NO. 7: Identify and describe the immediate action taken by [Taxpayer] with respect to [the capital gain from the stock redemption] once it was received by [Taxpayer], including specific accounts into which cash was deposited (and how much into each account, if more than one) as well as the immediate action taken by [Taxpayer] with respect to consideration received in noncash forms.
ANSWER: $94,106,645 was distributed by [Taxpayer] to the [Taxpayer] partners.

[12] The documents produced by Taxpayer, in part pertinent, included a list of the recipients of the $94,106,645 distributed by Taxpayer, mentioned in Taxpayer's response to Interrogatory No. 7.

[13] Taxpayer provided the following response, in part pertinent, to the Department's second request for interrogatories:

INTERROGATORY NO. 1: Identify and explain the purpose of the redemption . . . from the perspective of [Taxpayer and its predecessor], shareholders or partners of any member of the Blue Bell family of entities, and any other individuals or entities affected by the redemption.
ANSWER: The purpose of reorganization that took place on 12/13/2000-01/01/2001 was to reorganize [BBC USA] so that it could remain a private company for an indefinite period of time, thereby avoiding the expense and inconvenience of registering its securities and publicly reporting its financial results and so that its stockholders may receive "pass-through" tax treatment. Due to the limitation on the number of S Corporation shareholders allowed, the redemption was necessary to "move" individual shareholders from [BBC USA] to [Taxpayer].

In support of its motion for summary judgment, Taxpayer relied upon Mr. Rankin's affidavit[14] and deposition and its Statement of Uncontested Material Facts.[15]

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[14] Mr. Rankin's affidavit included the followings averments, in part pertinent:

> 2. [Taxpayer] is in the business of producing, selling, and distributing ice cream both within and outside the state of Tennessee.
> 3. [BBC USA] is a holding company and does not conduct any business operations in Tennessee or elsewhere.
> ***
> 8. [Taxpayer's] monetary holding of BBC USA stock and the redemption of the stock by BBC USA was a part of an extraordinary, one-time reorganization transaction of BBC USA and affiliates and not part of any ongoing business activity or trade of [Taxpayer].
> 9. [Taxpayer's] monetary holding of BBC USA shares and the redemption of those shares by BBC USA was not an integral part of [Taxpayer's] regular trade or business operations.
> 10. The shares of BBC USA stock were contributed to [Taxpayer] by individual shareholders of BBC USA, and the gain from the stock redemption was allocated to the individual shareholders of BBC USA because the appreciation occurred while the stock was held by the shareholders prior to contribution to [Taxpayer].
> 11. [Taxpayer's] momentary ownership of BBC USA stock did not serve any operational function or purpose for [Taxpayer] and did not in any way further [Taxpayer's] production, sale, or distribution of ice cream in the state of Tennessee.

[15] In its Statement of Uncontested Material Facts, Taxpayer made certain assertions of fact, to which the Department provided the following responses, in part pertinent:

Centralization of Management

As evidenced by Taxpayer's answer to the Department's Interrogatory No. 3, there is no dispute as to BBC USA's ownership of Taxpayer. "However, a business's choice of structure does not control whether

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7. On January 1, 2001, shortly after [Taxpayer's] acquisition of BBC USA stock by contribution, BBC USA redeemed its stock from [Taxpayer].
RESPONSE: Undisputed, presuming that "shortly after" means that the shares were redeemed later the same day.
8. [Taxpayer's] momentary holding of the BBC USA stock and the redemption of the stock by BBC USA was a part of an extraordinary, one-time reorganization transaction of BBC USA and affiliates and not part of any ongoing business activity or trade of [Taxpayer].
RESPONSE: Undisputed that the redemption was a part of an extraordinary, one-time reorganization transaction of BBC USA and affiliates. No response to remainder of the statement . . . is appropriate . . . as it presumes a legal conclusion and is thus a statement of law rather than a statement of fact . . . To the extent that the Court finds that a response to this portion of the statement is appropriate . . . , it is disputed as a matter of law because the redemption produced earnings which are business earnings for [Taxpayer] under the functional test.
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10. The shares of BBC USA stock were contributed to [Taxpayer] by individual shareholders, and the gain from the stock redemption was allocated to the individual shareholders because the appreciation occurred while the stock was held by the shareholders prior to contribution to [Taxpayer].
RESPONSE: Undisputed that "the shares of BBC USA stock were contributed to [Taxpayer] by individual shareholders." With respect to the rest of the statement, the [Department] is unable to respond because the statement does not state for what purpose "the stock redemption was allocated to the individual shareholders."

a business is unitary." *Louis Dreyfus Corp.*, 933 S.W.2d at 469. The "unity of ownership alone does not necessarily indicate that the various components of a business are substantially interdependent on each other," but rather "[a] more significant inquiry concerns the control of the business' activities." *Id.* "This inquiry should consider not only the extent of centralized control of the business but also the existence and extent of control that the business' components have over the activities of the other components." *Id.*

In its response in opposition to Taxpayer's motion for summary judgment, the Department relied upon the fact that "[t]he Second Amended and Restated Plan of Reorganization was formulated and adopted centrally on behalf of all the entities" to evidence the "central management" of the related entities. While there is evidence of overlap in the management of the entities,[16] the record does not reflect sufficient control on the part of BBC USA over Taxpayer's activities in Tennessee to support a finding of centralized management. In fact, the Department's Statement of Undisputed Material Facts asserted that "[t]he actual operation of the . . . ice cream business was *controlled, managed, and conducted* by [Taxpayer's predecessor] prior to the Reorganization and by [Taxpayer] afterward" (emphasis added); this assertion was undisputed by Taxpayer. In the absence of evidence establishing BBC USA's control over Taxpayer's activities, we find that there was not centralized

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[16] The Department cites the fact that Paul Kruse signed the Redemption Agreement in his capacities as Vice President of BBC USA and as Vice President of the general partner of Taxpayer.

management of the entities for purposes of the hallmarks of a unitary relationship test.

Functional Integration

For there to be functional integration between a business's components, "there must be a substantial interrelationship or interdependence among its basic operations." *Louis Dreyfus Corp.*, 933 S.W.2d at 469. "A business is unitary when the operation of one of its components depends upon and contributes to the operation of its other components." *Id.* at 467. "[A] unitary business may exist without a flow of goods between the parent and subsidiary, if instead there is a flow of value between the entities." *Allied-Signal*, 504 U.S. at 783. However, the "United States Supreme Court has recognized that one component may 'add to the riches' of the corporation and yet remain a discrete business enterprise." *Id.* at 470 (citing *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 328 (1982)).

In its response in opposition to Taxpayer's motion for summary judgment, the Department contended that the reorganization was evidence of functional integration because it was done for the purpose of benefitting the entire Business, from the ice cream making operations to the shareholders. In making this assertion, the Department relied upon an undisputed statement made in its Statement of Undisputed Material Facts, in which it said:

> 7. The Reorganization which was carried out from November 2000 through January 1, 2001, was undertaken for the purpose of allowing [BBC USA] and *the Business as a whole to*

> remain a private company for an indefinite period of time, thereby avoiding the expense and inconvenience of registering its securities and publicly reporting its financial results and so that its stockholders may receive "pass through" tax treatment after effecting the transactions contemplated in this Second Amended and Restated Plan of Reorganization (the "Plan") by qualifying [BBC USA] or its successor, as an S corporation, as defined in [Internal Revenue] Code section 1361.

(Emphasis added). In its Memorandum and Order, the trial court presumed that the language "the Business as a whole" included the Taxpayer, but questioned the benefits conferred upon Taxpayer by the reorganization because "the source for [the Department's statement] [wa]s BBC USA's Second Amended and Restated Plan of Reorganization" and "the actual text of the Plan of Reorganization . . . d[id] not state that the reorganization benefits the business as a whole," but rather that "the benefits on the less reporting time inure to BBC USA and the tax advantages apply to its shareholders."

Because of the above inconsistencies in the Department's position, the trial court ordered the Department to file a brief "to assist the Court in analyzing the functional integration between [Taxpayer] and BBC USA" by "explaining the concrete tax advantages and non-reporting and non-registering of securities advantages [Taxpayer] received from the stock redemption and where in the record these advantages are proven." In its final Memorandum, the

court concluded that "[t]here is no statement in the Plan and, thus, no factual basis in the record for the claim that the advantages of the reorganization are benefits shared by the [Taxpayer]" and that the Department has not, "independent of the record, articulated any discreet [sic] or more than incidental advantage to [Taxpayer]."

Upon a review of the record available to this Court,[17] we agree with the trial court's finding. Taxpayer's response to the Department's second request for interrogatories revealed that the "purpose of the reorganization . . . was to reorganize [BBC USA] so that it could remain a private company . . . , thereby avoiding the expense and inconvenience of registering its securities and publicly reporting its financial results and so that its stockholders may receive 'pass through' tax treatment."[18] As for Taxpayer's role in the reorganization, the Department acknowledged in its Statement of Undisputed Material Facts that "[t]he sole purpose of this redemption was to effectuate the Reorganization of the Business" and Taxpayer stated in its response to the Department's second request for interrogatories that the stock redemption's role in the reorganization was only "to 'move' individual shareholders from [BBC USA] to [Taxpayer]." The record does not contain sufficient evidence to prove that Taxpayer realized any benefits as a result of the reorganization or the stock redemption which contributed to Taxpayer's operations or which

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[17] The Department's supplement brief, if filed, cannot be found in the record.

[18] In answering the interrogatory, Taxpayer relied upon the Second Amended and Restated Plan of Reorganization.

Taxpayer depended on in performing its operations, *Louis Dreyfus Corp.*, 933 S.W.2d at 467, so as to justify a finding that BBC USA and Taxpayer were functionally integrated.

The Department also contends that BBC USA, as a pure holding company of Taxpayer, would "have no reason to exist" without Taxpayer's operation and that the United States Supreme Court has "held that the 'holding company function' is *not* a discrete, separate business." (Emphasis in original).

In making its assertion, the Department relied on the United States Supreme Court opinion in *Mobil Oil Corp. v. Comm'r of Taxes of Vt.*, 445 U.S. 425 (1980), in which that court addressed a taxpayer's argument for the classification of a holding company as a separate business:

> Nor do we find particularly persuasive Mobil's attempt to identify a separate business in its holding company function. *So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise,* those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability.

Id. at 440 (emphasis added). While we agree that the Court found that holding companies are not automatically separate businesses from their subsidiaries, we do not adopt the Department's assertion that holding companies are *never* separate businesses; rather, to be unitary with its subsidiary,

the income earned by a holding company must "derive[] from a functionally integrated enterprise." The parties and the trial court agreed that Tennessee caselaw has not addressed functional integration in the context of holding companies; instead, the parties' relied upon, and the trial court adopted, the analysis conducted by courts in other jurisdictions.

The court in *In the Matter of the Appeals of PBS Bldg. Sys., Inc., et. al.*, 1994 Cal. Tex. LEXIS 434 (Nov. 17, 1994) stated that "there is no . . . separate standard or higher burden of proof which holding companies must meet in order to be held unitary with operating subsidiaries" and that "where pure or passive holding companies are involved, it is relevant to carefully inquire into the nature of the benefits accruing on both the holding company and the operating subsidiaries as a result of their corporate structure." *Id.* at *7, *13-14. In addressing the components of functional integration with a holding company, the court recognized that "flows of value or contribution and dependency may take the form of shared tax benefits . . . , intercompany financing (loans, loan guarantees and debt retirement) or improved credit worthiness (bond security, more favorable insurance rating or interest rates on borrowed capital)." *Id.* at* 14.

The court in *A.B. Dick Co. v. McGraw*, 678 N.E.2d 1100 (Ill. App. Ct. 1997) held that "[t]he fact that a holding company owns controlling interest in several corporations is not enough to make the group a unitary business." *Id.* at 1102 (citing *Mobil Oil Corp.*, 445 U.S. at 440). The court further stated that "[t]here must be something "'beyond the mere flow of funds arising out of a passive investment or distinct business

operation"'" and that "[t]here must be more than the type of occasional oversight "'that any parent gives to an investment in a subsidiary."'" *Id.* at 1102 (citing *Citizens Utilities v. Dep't of Revenue*, 488 N.E.2d 984, 990 (Ill. 1986), in turn quoting *Container Corp.*, 463 U.S. at 166, and quoting *Container Corp.*, 463 U.S. at 180).

As was held in *Mobil Oil* and *PBS Bldg. Sys.*, functional integration must still be present in order for BBC USA, as a holding company, to be considered a single unitary business with Taxpayer, its subsidiary. As stated earlier, the Department acknowledged that "[t]he actual operation of the . . . ice cream business was controlled, managed, and conducted by [Taxpayer's predecessor] prior to the Reorganization and by [Taxpayer] afterward" and that BBC USA "was a holding company that did not conduct any business operations." Furthermore, as stated earlier, the reorganization was for the sole purpose of converting BBC USA into an S corporation so BBC USA and its remaining shareholders could obtain favorable tax treatment and avoid registering and reporting expenses; there is no evidence in the record that Taxpayer realized these benefits. As for the stock redemption, while Taxpayer did realize a capital gain, the redemption was undertaken to effect the reorganization by "moving" some of BBC USA's shareholders from BBC USA to Taxpayer and the evidence in the record suggests that the capital gains were distributed to the "moved" shareholders because the stock's value appreciated while in their possession. Lastly, Taxpayer's contribution of the income it earned from the ice cream making operations to BBC USA, without more, is insufficient to prove functional integration since Taxpayer can "add to the riches" of

the Business, while maintaining its status as a "discrete business enterprise." *Allied-Signal*, 504 U.S. at 783. The evidence proffered by the Department, recited above, fails to establish the requisite flow of value, *Allied-Signal*, 504 U.S. at 783, or substantial contribution and dependency, *Louis Dreyfus Corp.*, 933 S.W.2d at 467; consequently, the Department failed to rebut the Taxpayer's evidence that the two entities were not functionally integrated.

Economies of Scale

In the context of economies of scale, this Court in *Louis Dreyfus Corp.*, *supra.*, asked whether a parent corporation's provision of "central services" to its subsidiary undermined the subsidiary's "operational independence." *Louis Dreyfus Corp.*, 933 S.W.2d at 471. Such "central services" included staff functions; common operational resources; payment of employees' salaries, pension plans, benefits packages, and workman's compensation coverage; legal services; and accounting services. *Id.*

Upon a review of the record, we find there to be no evidence that BBC USA provided any "central services" to Taxpayer which undermined its "operational independence." In fact, as stated earlier, the Department conceded that "[t]he actual operation of the . . . ice cream business was *controlled, managed, and conducted* by [Taxpayer's predecessor] prior to the Reorganization and by [Taxpayer] afterward." (Emphasis added).

In the absence of any centralized management, functional integration, or economies of scale, we find that BBC USA and Taxpayer were not a unitary

business under the "hallmarks of a unitary relationship" test.

2. Operational Function Test

In addition to the "hallmarks of a unitary relationship" test, the United States Supreme Court created the "operational function" test, which acknowledged that "situations could occur in which apportionment might be constitutional even though the 'payee and the payor [were] not . . . engaged in the same unitary business,'" *MeadWestvaco Corp.*, 128 S.Ct. at 1507 (quoting *Allied-Signal, Inc.*, 504 U.S. at 787), and that "[w]hat is required instead is that the capital transaction serve an operational rather than an investment function." *Allied-Signal, Inc.*, 504 U.S. at 787. This test was "not intended to modify the unitary business principle by adding a new ground for apportionment," but rather it "simply recognize[d] that an asset can be a part of a taxpayer's unitary business even if . . . a 'unitary relationship' does not exist between the 'payor and payee.'" *MeadWestvaco Corp.*, 128 S.Ct. at 1507; *Allied-Signal, Inc.*, 504 U.S. at 787 (a "payee and . . . payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases"). In explaining this test, the Court offered the following hypothetical:

> Hence, for example, a State may include within the apportionable income of a nondomiciliary corporation the interest earned on short-term deposits in a bank located in another State if that income forms part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank.

Allied-Signal, Inc., 504 U.S. at 787-88.

In its response in opposition to Taxpayer's motion for summary judgment, the Department maintained that BBC USA and Taxpayer were unitary under the first test, but nevertheless argued that, if BBC USA and Taxpayer were found not to be unitary, the "income at issue *does* meet the operational function test" because the reorganization was "designed to increase the value of the entire business to stakeholders - value whose ultimate fount is the ice cream operations actually conducted by [Taxpayer]" and, consequently, that the reorganization was a necessary operational function to Taxpayer's ice cream making operations.

The undisputed purpose of the stock redemption was to effectuate the reorganization, which required certain BBC USA shareholders, not obtaining an interest in the new S corporation, to be "moved" to Taxpayer. Taxpayer stated, in its response to the Department's interrogatories, that the capital gains it realized as a result of the stock redemption were distributed to its partners and, in response to the Department's request for documents, Taxpayer produced a list of those cash distributions. The Second Amended and Restated Plan of Reorganization clearly stated that the redemption was a "taxable event" and that it would "cause *participants in the LP Offering* to pay Federal income tax based on the gain *they* recognize from the Redemption." (Emphasis added). Lastly, Mr. Rankin, in his affidavit, asserted that "the gain from the stock redemption was allocated to the individual shareholders of BBC USA because the appreciation occurred while the stock was held by the shareholders prior to contribution to [Taxpayer]."

Based upon the above evidence, we find that the capital gains realized by Taxpayer were not used as operational funds, but rather were distributed to Taxpayer's partners, who were entitled to the earnings since they were in possession of the BBC USA stock at the time it appreciated. While the Department continued to maintain that the reorganization was effected for the purpose of benefitting the entire Business, we find no evidence of such. Instead, the Second Amended and Restated Plan of Reorganization and Taxpayer's responses to the Department's Undisputed Statement of Material Facts, interrogatories, depositions, and document requests reveal that the reorganization was done for the purpose of providing tax benefits to BBC USA's shareholders and avoiding BBC USA's incurrence of registering and reporting expenses. Consequently, we find that, pursuant to the operational function test, the Department was not constitutionally permitted to assess a tax on Taxpayer's non-operational earnings.

IV. Conclusion

Based on our finding that the Department's tax assessment was unconstitutional, the issue regarding the classification of Taxpayer's earnings as "business earnings" has been rendered moot.

For the reasons set forth above, the decision of the Chancery Court is AFFIRMED. Costs are assessed against the Department, for which execution may issue if necessary.

/s/ Richard H. Dinkins
RICHARD H. DINKINS, JUDGE

IN THE COURT OF APPEALS OF TENNESSEE
AT NASHVILLE
July 9, 2009 Session

No. M2009-00255-COA-R3-CV

[Filed September 29, 2009]

BLUE BELL CREAMERIES, L.P.	)
	)
v.	)
	)
LOREN CHUMLEY, COMMISSIONER DEPARTMENT OF REVENUE, STATE OF TENNESSEE	)
	)

Appeal from the Chancery Court
for Davidson County
No. 06-414-III

JUDGMENT

This cause came on to be heard upon the record on appeal from the Chancery Court for Davidson County, briefs, and oral argument; upon consideration whereof, this Court is of the opinion that the judgment of the Chancery Court should be affirmed.

In accordance with the opinion of the Court filed herein, it is, therefore, ordered and decreed by this Court that the judgment of the trial court is affirmed. The case is remanded to the Chancery Court for Davidson County for further proceedings in accordance with the judgment and the opinion of this Court.

Costs of this appeal are assessed against the Department for which execution may issue if necessary.

APPENDIX C

**IN THE CHANCERY COURT
OF DAVIDSON COUNTY, TENNESSEE
TWENTIETH JUDICIAL DISTRICT
PART III, AT NASHVILLE**

No. 06-414-III

[Filed January 5, 2009]

BLUE BELL CREAMERIES, LP,	)
	)
Plaintiff,	)
	)
v.	)
	)
LOREN L. CHUMLEY, COMMISSIONER DEPARTMENT OF REVENUE, STATE OF TENNESSEE	)
	)
Defendant.	)

FINAL ORDER

This case was heard on cross-motions for summary judgment pursuant to Tenn. R. Civ. P. 56. On November 13, 2008, this Court issued a "Memorandum" holding that summary judgment would be granted in favor of the Plaintiff, Blue Bell

Creameries, LP, denying summary judgment to the Defendant Commissioner of Revenue, and directing Plaintiff's counsel to "prepare a final order for a refund, stating the precise amount, addressing the issues of interest and attorneys fees, and taxing costs to the Defendant." That Memorandum is incorporated herein by reference.

Having determined all of the claims of the Plaintiff in this matter, the Court finds that there is no just reason for delay in entering a final, appealable judgment as to all matters other than attorneys' fees and expenses. Pursuant to Tenn. R. Civ. P. 54.02, therefore, the Court grants summary judgment to the Plaintiff, denies summary judgment to the Commissioner, and expressly directs that a final, appealable judgment is hereby entered as described in the "Memorandum" awarding Plaintiff a refund in the amount of $164,779.07 as well as statutory interest continuing to accrue on the tax principal of $121,309.74 from December 31, 2008, until the refund is paid.

The Court determines that the Plaintiff is the prevailing party in this litigation and it is awarded its attorneys' fees and expenses incurred in defending this action pursuant to Tenn. Code Ann.§ 67-1-1803(d). However, the Court reserves judgment as to the amount of fees and expenses to be award until any and all appeals in this matter are finally adjudicated. The prevailing party shall therefore file a claim with this Court for the award of fees and expenses under Tenn. Code Ann.§ 67-1-1803(d) within ninety (90) days of the entry of this Final Order or within sixty (60) days of the issuance of the final mandate concluding all

proceedings in the appellate courts in this case, whichever date is later.

Costs of this cause are assessed against the Commissioner of Revenue.

IT IS SO **ORDERED.**

/s/ Ellen Hobbs Lyle
ELLEN HOBBS LYLE
CHANCELLOR

PREPARED FOR ENTRY BY:

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* * *

APPENDIX D

IN THE CHANCERY COURT
FOR THE STATE OF TENNESSEE
20TH JUDICIAL DISTRICT
DAVIDSON COUNTY
PART THREE

NO. 06-414-III

[Filed November 13, 2008]

BLUE BELL CREAMERIES, LP,	)
	)
Plaintiff.	)
	)
VS.	)
	)
LOREN L. CHUMLEY, COMMISSIONER, DEPARTMENT OF REVENUE, STATE OF TENNESSEE,	)
	)
Defendant.	)

MEMORANDUM

Tennessee imposes on all persons doing business in the state an excise tax of a set percentage of their net earnings for the next preceding fiscal year. Tenn. Code Ann. § 67-4-2007(a). "Net earnings" includes federal

taxable income as provided in certain sections of the Internal Revenue Code. Tenn. Code Ann. § 67-4-2006(a).

Reported as income on the plaintiff's federal tax return was $119,909,317.00 of total capital gains from a stock transaction between the plaintiff and a holding company (based in Delaware) who directly and indirectly owns the various interests that comprise the plaintiff. The defendant Commissioner of Revenue assessed Tennessee excise tax on the stock transaction. The plaintiff, a Delaware based limited partnership who produces, sells and distributes ice cream in the State of Tennessee and elsewhere, has filed this lawsuit for a refund of excise tax in the amount of $120,921.00.

The plaintiff's position is that even though the stock transaction resulted in capital gains for federal income tax purposes, the transaction is not subject to excise tax in Tennessee under either federal constitutional law or Tennessee tax statutes. The transaction was part of an extraordinary, one-time reorganization of the holding company and its affiliates in which the plaintiff momentarily held stock of the holding company who then redeemed the stock. This transaction and the resulting payment for the stock, the plaintiff asserts, lack the systemic and/or operational connections to the plaintiff's business in Tennessee required by federal and Tennessee tax law. This matter is presently before the Court on cross-motions for summary judgment pursuant to Rule 56 of the Tennessee Rules of Civil Procedure.

After reviewing the record and considering the arguments of counsel, the Court grants the plaintiff's

motion and denies the defendant's motion. The sole basis for the ruling is the federal constitutional ground. The undisputed facts establish that plaintiff and the holding company are not a unitary business under either the hallmarks of unity or the operational function test. That finding is dispositive of the case. As to the second issue regarding whether the income constitutes business earnings under the Tennessee statutes, the Court concludes there are insufficient facts in the record to make a ruling on that.

The facts and reasoning on which the Court bases its decision are as follows.

Undisputed Material Facts

The parties' respective statements of Uncontested Material Facts establish that prior to November 5, 2000, Blue Bell Creameries, USA. Inc. ("BBC USA") was a Delaware based holding company, owning the assets and properties of the related businesses and legal entities who make and sell Blue Bell Ice Cream, such that certain interests of the operating entity, who was plaintiff's predecessor, were indirectly owned by BBC USA. Defendant's Statement of Undisputed Material Fact ("DSUMF") No. 1, 3 and 4.

In November of 2000, BBC USA decided to reorganize to become an S corporation under section 1361 of the Internal Revenue Code. DSUMF No. 7. The purposes of the reorganization was for BBC USA to remain a private company for an indefinite time thereby avoiding the expense and inconvenience of registering its securities and publicly reporting its financial results, and to provide "pass-through" tax treatment to its stockholders. DSUMF 7.

To become an S corporation; BBC USA had to redeem its shares. It did this by first providing a limited number of its shareholders an exchange of their BBC USA stock for S Corp shares. DSUMF 8. To redeem the rest of its shares, BBC USA formed an operating company, the plaintiff.

The formation of the plaintiff was accomplished by the wholly-owned subsidiaries of BBC USA contributing their assets to obtain controlling shares in the plaintiff operating company. DSUMF 9. There were also transactions in which the predecessor of the plaintiff, who conducted the operations of the ice cream business and who was directly and indirectly owned by BBC USA, contributed its assets and liabilities to the plaintiff and liquidated into a limited partner. DSUMF 2, 5, 13, 14.

To achieve the redemption of the outstanding BBC USA shares, the plaintiff operating company offered certain BBC USA stockholders the opportunity to exchange all of their BBC USA shares for an equal number in the limited partnership interest of the plaintiff operating company. DSUMF 10. On January 1, 2001, the plaintiff operating company acquired by contribution and momentarily held shares of BBC USA stock. Plaintiff's Statement Undisputed Material Facts ("PSUMF") No. 6. On that same day, BBC USA redeemed its stock from the plaintiff. PSUMF 7. The redemption was an extraordinary, one-time reorganization transaction of BBC USA and affiliates. PSUMF 8. The redemption payment of $142,506,000.00, resulting in total capital gains of $119,909,317.00 and includable in the plaintiff's federal taxable income, DSUMF 17, was then assessed for excise tax by the defendant, DSUMF 18. At no time

during the relevant events did BBC USA produce, sell or distribute ice cream as does the plaintiff. PSUMF 3. BBC USA was and is purely a holding company. PSUMF 3. After the reorganization and currently, BBC USA directly or indirectly owns 100% of the stock and interests that comprise the plaintiff.

Federal Constitutional Issues

Because of the burden and inhibition it places on interstate commerce, taxation by a state of the multistate income of a nondomiciliary corporation has been determined by the United States Supreme Court to implicate the Commerce Clause of the United States Constitution. *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 772 (1992) (citing *Mobile Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 436-437 (1980)). Consistent with the Commerce Clause, a state cannot, as a general rule, tax value earned beyond its borders unless, the United States Supreme Court has held, the tax is applied to an activity with a substantial nexus to the state, the tax is fairly apportioned and is fairly related to the services provided by the taxing state. *Louis Dreyfus Corp. v. Huddleston*, 933 S.W.2d 460, 465 (Tenn. App. 1996). Where the issue comes up, for example, is in the case of a wholly owned subsidiary, located in Tennessee, which has a stand alone operation, but also has access to the non-domiciliary parent's capital base, computer technology and other benefits. *Id.* In such cases, the Untied States Supreme Court has developed, to assist with analyzing the connection to the state, the unitary business principle: the value of a unitary business is apportionable to a state for taxation if the business' operations within the State

contribute to or benefit from the corporation's unitary business. *Id.* at 466.

A unitary business is a business whose components are too closely connected and necessary to each other to justify division or separate consideration as independent units *Id.* at 467. States may not include in a business' apportionable tax base income not derived directly from an unrelated business activity constituting a discrete business enterprise that is not part of the taxpayers unitary business. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 780, 112 S. Ct. 2251, 2259 (1992). The underlying unity or diversity of a business does not necessarily depend on the form or structure of its organization, or on the business' purpose. *Louis Dreyfus*, 933 S.W.2d at 467. Accordingly, a single corporation may carry on two or more discrete businesses without these businesses being considered unitary. *Id.* The proper focus is on the underlying unity or diversity of the business and the relationship between the activities of the component in the taxing state and the activities occurring elsewhere, not just on the common relationships between the various components and the central structure of the business. *Id.*

Under the unitary business principle, a court is to consider different aspects of the business in relation to the taxable transaction to determine if there is unity between the two. *Allied-Signal, Inc.*, 504 U.S. at 781. The three aspects courts generally analyze are whether there is functional integration, centralization of management and economics of scale. These three aspects are known as the hallmarks of unity. Their application is illustrated in the decision of the

Tennessee Court of Appeals in *Louis Dreyfus Corp. v. Huddleston*. 933 S.W.2d 460 (Tenn. Ct. App. 1996).

That case involved corporate excise tax liability of a nondomiciliary corporation of agricultural commodities who maintained a wholly owned commodities subsidiary in Tennessee. The Tennessee subsidiary was a stand alone operation but had access to the capital base, computer technology and worldwide communications system of the nondomiciliary corporate parent. The latter paid corporate excise tax to Tennessee apportioning business earnings from its six commodities groups. The corporation did not including earnings from a division which engaged in bond trading but not agricultural commodities and which was located in Connecticut with no customers or inventory. The Commissioner of Revenue assessed deficiencies because the corporation had not included investment earnings from the bond trading division. The trial court ordered a refund, finding that the activities of the bond trading division were income but not part of the corporation's unitary business.

Affirming the trial court, the Court of Appeals described the functional integration factor as requiring "a substantial interrelationship or interdependence among its basic operations." *Id.* at 469. The court concluded that there was no functional integration because of separation of the bond trading group from the commodities groups in geography, equipment, finances and employees:

> The Bond Trading Group has no operational relationships with the Louis Dreyfus Corporation's six commodities group. Its

> business activities are discrete from the other groups. In addition, its offices are geographically separated from the other corporate offices; it uses separate telecommunications and computer systems; and it maintains separate financial relationships that are not available to the other groups. It does not share employees with the other groups or participate in common training programs, and its employees do not rotate to and from the commodities groups. The Bond Trading Group could easily exist and operate without the commodities groups. It neither depends on nor contributes to the business operations of the commodities groups . . .

Louis Dreyfus, 933 S.W.2d at 469-470.

The court also found no centralization of management or economies of scale. *Id.* at 469 and 471. As to the former, the court concluded that although there were managerial links between the corporate parent and its bond trading division, there were no such links between the latter and the Tennessee wholly-owned subsidiary:

> Thomas Malone, Jr., Allenberg's executive vice president, testified that he had met Mr. Wayne (executive vice president of the trading group and vice president of Louis Dreyfus) only once and that his reporting relationship to the Louis Dreyfus Corporation differed from Mr. Wayne's. Neither Mr. Wayne nor Mr. Malone has any significant knowledge concerning each other's activities or business strategies.

Id. at 469. As to the economies of scale, the court found that there was no evidence in the record of any interdependence between the bond trading division and the Tennessee wholly owned subsidiary:

> The Bond Trading Group has benefitted to some extent from its affiliation with the Louis Dreyfus Corporation, but these benefits, considered in light of the other factors, are not significant enough to require the courts to find that the activities of the Bond Trading Group were unitary with those of the corporation's six commodities divisions.

Id. at 471.

Although numerous courts have analyzed and applied the hallmarks of unity as illustrated by the *Louis Dreyfus* decision, few have done so in the context of holding companies. There is one decision, however, which has specifically considered whether holding companies can form a unitary business with operating companies.

In the Matter of Appeals of PBS Bldg. Sys., Inc., et al., 1994 Cal. Tax. LEXIS 434 (Nov. 17, 1994), the California Board of Equalization in *PBS* held that there was no *per se* rule that holding companies are non-unitary. *Id.* at *7. In other words, depending on the facts of each individual case, a holding company can be unitary with an operating company. The *PBS* decision further established that to "determine whether holding and operating companies are unitary, no special test exists, but instead the standard test for unitariness - i.e. the hallmarks of unity - would apply. *Id.*, * 11.

The Board went on to state that where pure or passive holding companies are involved "it is relevant to carefully inquire into the nature of the benefits accruing to both the holding company and the operating subsidiaries as a result of the corporate structure." The Court mentioned intercompany financing such as loans, guaranties or debt retirement, or improved credit worthiness:

> For example, even in the most extreme circumstance, where a pure holding company lacks even acquisition debt, an operating company it holds may gain significant advantages, such as insulation from liability. Consequently, in the typical case where a group of corporations conduct only one unitary business, it would be expected that the requisite contribution or dependency would exist between the "ultimate parent" holding company and its operating subsidiary or subsidiaries. It is important to recognize that flows of value or contribution and dependency may take the form of shared tax benefits (Hugo Neu-Proler), intercompany financing (loans, loan guarantees and debt retirement) or improved credit worthiness (bond security, more favorable insurance rating or interest rates on borrowed capital.

PBS Bldg. Sys., 1994 Cal. Tax. LEXIS 434 * 14.

Although *PBS* is not binding on this Court, in the absence of Tennessee law on the issue, the Court finds it persuasive: depending on the circumstances of each case, a subsidiary can be unitary with its parent holding company. The Court further concludes that the

hallmarks of unity would apply to determine whether the two entities are in fact a unitary business.

Also persuasive is *A.B. Dick Co. v. McGraw*, in which the Illinois Court of Appeals held that the fact that a holding company owns controlling interest in several corporations is insufficient to make the group a unitary business. 678 N.E.2d 1100, 1102. (Ill. App. Ct. 1997). Specifically, the Court held that "there must be something 'beyond the mere flow of funds arising out of a passive investment or a distinct business operation . . . There must be more than the type of occasional oversight 'that any parent gives to an investment in a subsidiary." *Id.* (citations omitted). *See* also *The First Nat'l Bank of Manhattan v. Kansas Dep't of Revenue*, 779 P.2d 457 (Kan. Ct. App. 1989)(finding that a holding company was not unitary with its operating company).

Turning now to the facts of the case at bar, plaintiff claims it is not unitary with BBC USA. The plaintiff must show this by clear and cogent evidence. *Louis Dreyfus Corp. v. Huddleston*, 933 S.W.2d 460, 467 (Tenn. App. 1996). Clear and cogent evidence is more than a preponderance but does not have to be uncontradicted or remove all reasonable doubt. *Id.* at 468.

The Court finds that the plaintiff has met its burden of showing that it is not unitary with BBC USA. First, the undisputed facts of record are that the plaintiff is an operating company that produces, sells and distributes ice cream in Tennessee as well as other states. BBC USA, on the other hand, is a Delaware holding company. It produces, sells and distributes nothing. Secondly, the parties' Statements of

Undisputed Material Facts do not include any facts concerning the hallmarks of unity. There are no facts regarding transactions not undertaken at arms length or management roles of the parent company in the subsidiary, as considered in *Allied-Signal*. There are also no facts of shared geography, equipment, finances or employees examined by the Tennessee Court of Appeals in *Louis Dreyfus*. There are no facts of intercompany financing (loans, guaranties, retirement of debt) or improved credit worthiness identified in *PBS Building Systems*.

The defendant supports its argument that the plaintiff and BBC USA are unitary with general propositions that the plaintiff is 100 percent owned and controlled by BBC USA; the reorganization that resulted in the redemption and capital gain was centrally organized by BBC USA; and the enduring tax advantage for BBC USA's shareholders of the reorganization also benefits the plaintiff. These, the Court concludes, are insufficient for several reasons.

As noted above, in both *Louis Dreyfus* and *A.B. Dick Co.*, corporate form, such as a holding company, is not dispositive. Accordingly, the fact that the plaintiff is owned by BBC USA is not enough to demonstrate unitariness.

The other facts relied upon by the defendant—central planning of the reorganization by BBC USA and the resulting tax advantages for shareholders—the Court concludes, as well, do not establish unitariness. In this regard the defendant asserts in DSUMF No. 7 that not only BBC USA but "the Business as a whole [this presumably includes the plaintiff]" obtained tax and reporting benefits from the

reorganization. The source for this statement cited by the defendant is BBC USA's Second Amended and Restated Plan of Reorganization, *see* DSUMF No. 7. The actual text of the Plan of Reorganization, however, does not state that the reorganization benefits the business as a whole. The Plan states that the benefits on less reporting inure to BBC USA and the tax advantages apply to its shareholders. There is no statement in the Plan and, thus, no factual basis in the record for the claim that the advantages of the reorganization are benefits shared by the plaintiff. Nor has the defendant, independent of the record, articulated any discreet or more than incidental advantage to the plaintiff. Finally, if the reorganization did not benefit the plaintiff, the central planning of the reorganization is also not an indication of unitariness. As the California Board of Equalization stated in *PBS,* there must be "flows of value or contribution and dependency" between the entities. *In the Matter of the Appeals of PBS Bldg., Sys., Inc., et al.,* 1994 Cal. TAX LEXIS 434 *14 (Nov. 17, 1994).

The Court, therefore, finds from the facts of record no unitariness between plaintiff and its parent holding company, BBC USA.

Even in the absence of a unitary relationship, "there are situations in which apportionment might be constitutional even though 'the payee and the payor' [were] not . . . engaged in the same unitary business." *Meadwestvaco Corp. v. Illinois Dep't of Revenue*, 128 S. Ct. 1498, 1507. (2008) (citing to *Allied-Signal Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 787 (1992)). An asset "could form part of a taxpayer's unitary business if it served an 'operational rather than an investment function' in that business." *Meadwestvaco Corp*, 128 S.

Ct. at 1507. This test is known as the operational function test. "[I]n order to exclude certain income from the apportionment formula, the company must prove that 'the income was earned in the course of activities unrelated to [those carried out in the taxing] State." *Allied-Signal Inc.*, 504 U.S. 768, 787.

To meet the operational function test, the operating company must have obtained concrete advantages from the holding company, such as insulation from liability, shared tax benefits, and inner company loans. *A.B. Dick, Co. v. McGraw*, 678 N.E.2d 1100, 1102 (Ill. App. Ct. 1997).

Again, defendant contends that plaintiff obtained tax advantages and lack of public reporting regulation due to BBC USA's reorganization. In support of this position, defendant cites to BBC USA's Second Amended and Restated Plan of Organization. As detailed *infra*, that document, however, states advantages only for BBC USA and its shareholders, not to the plaintiff.

Besides tax and reporting advantages, the defendant alludes to no other advantages, and the Court has located no other facts in the record to establish any concrete advantages plaintiff obtained from BBC USA. Additionally, in supplement filings requested in an August 15, 2008 order, the defendant was unable to provide additional facts regarding advantages received by plaintiff. The Court, therefore, finds that the operational function test, as well, has not been met.

Accordingly, based on the Court's findings that plaintiff and BBC USA are not a unitary business and

that the operational function test is not met, taxation by the State of Tennessee of the capital gains the plaintiff realized from the redemption transaction in issue violates the federal Constitution. The Court therefore grants plaintiff's motion for summary judgment and denies defendant's motion for summary judgment.

Tennessee Tax Statute Issues

Although the Court's decision on the constitutional question is dispositive of the case, the Court shall nevertheless address the business earnings issue in anticipation of an appeal.

For tax purposes, a corporation doing business in several states must divide its income among those states. *Gen. Care Corp. v. Olsen*, 705 S.W.2d 642, 644 (Tenn. 1986). How the income is divided depends on whether the income is classified as business earnings or nonbusiness earnings. *Id.* Nonbusiness earnings are allocated to a particular state based on the source of the income. *Id.* Business earnings, on the other hand, are apportioned, meaning the corporate income is divided among the states in which the taxpayer operates, according to a three-factor formula.[1] *Gen. Care Corp.*, 705 S.W.2d at 644.

Tennessee defines nonbusiness earnings as all earnings other than business earnings. Tenn. Code Ann. § 67-4-2004(14). "Business earnings" is defined as:

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[1] The three-factor formula has been omitted since it is not relevant here.

> [E]arnings arising from transactions and activity in the regular course of the taxpayer's trade or business or earnings from tangible and intangible property if the acquisition, use, management or disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations.

Tenn. Code Ann. § 67-4-2004(1). The statute goes on to provide that "in essence, earnings which arise from the conduct of the trade or trades or business operations of a taxpayer are 'business earnings,' and the taxpayer must show by clear and cogent evidence that particular earnings are classifiable as nonbusiness earnings." *Id.*

States with similar definitions of "business earnings" have interpreted it to include two separate, alternative tests: a transactional test and a functional test.[2] The transactional test is found in the first clause of the business earnings definition - "earnings arising from transactions and activity in the regular course of the taxpayer's trade or business." *Gen. Care Corp.* at 644. Under the transactional test, the "controlling factor by which business income [is identified] is the nature of the particular transaction giving rise to the

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[2] Under a previous definition of "business earnings," the Tennessee Supreme Court held that the state statute only included the transactional test. *Gen. Care Corp. v. Olsen*, 705 S.W.2d 642 (Tenn. 1986). Although the Supreme Court has not explicitly addressed whether the amended definition of "business earnings" includes the functional test, the parties do not dispute that both tests are now included in the definition. *See* Commissioner's Resp. to Pl.'s Mot. for Summ. J. 11-12 and Pl.'s Resp. in Opp'n to Def.'s Mot. for Summ. J.

income." *Id.* (citing *Western Natural Gas Co. v. McDonald*, 446 P.2d 781, 783 (Kan. 1968)). "The frequency and regularity of similar transactions and the former practices of the business are pertinent considerations." *Id.* (citing *Atlantic Richfield Co. v. State*, 601 P.2d 628, 631 (Colo. 1979) and *Western Natural Gas*, 446 P.2d at 784.) Also relevant in applying the transactional test is the taxpayer's subsequent use of the income. *Gen. Care Corp.*, 705 S.W.2d at 644. "[E]arnings held for use in the regular course of on-going business operations or expended to acquire assets to be used in the regular course of future business activities, have been held to be properly apportionable as business income." *Id.*

Because the relevant considerations under the transactional test include the frequency and regularity of similar transactions, the test is inapplicable to this case. As stipulated in the parties' Statement of Undisputed Material Facts, the transaction in which plaintiff acquired BBC USA stock and BBC USA subsequently redeemed that stock was part of an extraordinary, one-time reorganization. It was, then, admittedly, neither a frequent nor regular transaction for the plaintiff.

The test at issue here is the functional test. Unlike the transactional test, the "extraordinary nature or infrequency" of a transaction is irrelevant under the functional test. *Id.* It focuses on the second clause of the business earnings definition: "earnings from tangible and intangible property if the acquisition, use, management or disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations." *Id.* at 645. "Under the functional test, the income from the sale of an asset will be

considered business income if the asset produced business income while it was owned by the taxpayer." *Id.* Also, "if the property had an integral function in the taxpayer's unitary business, its income properly can be apportioned and taxed as business income, even though the transaction itself does not reflect the taxpayer's normal trade or business." *Id.* (citing *District of Columbia v. Pierce Assocs., Inc.*, 462 A.2d 1129, 1131 (D.C. 1983)).

Tennessee appellate courts have not applied the functional test since amending the business earnings definition. This Court, then, must look to other jurisdictions for guidance on applying the test. Numerous states have used it to analyze circumstances, such as those present in this case, where a business engages in an extraordinary, one-time transaction.

The California Supreme Court applied the functional test in *Hoechst Celenese Corp. v. Franchise Tax Board*. 22 P.3d 324 (Calif. 2001). In that case, the court had to decide whether surplus assets of a terminated pension plan and trust that reverted back to the corporation were considered business income.[3]

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[3] California's definition differs slightly from Tennessee's. First it uses the phrase "business income" rather than "business earnings." It defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible or intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations." *Hoechst Celenese Corp.*, 22 P.3d 331. Unless otherwise noted, all other states' definition of business

Id. The court held that the surplus assets were business income because they "contributed materially to Hoechst's production of business income via their effect on Hoechst's labor force." *Id.* at 343. In reaching this conclusion, the court found that Hoechst: 1) created the income-producing property - the pension plan and trust - in order to retain its current employees and to attract new employees; 2) had broad authority to amend the plan; 3) retained an interest in any surplus pension plan assets; 4) funded the plan with its business income and used the contributions to reduce tax liability; 5) exercised control over the plan and its assets through committees composed of its officers and employees; and 6) disposed of the pension plan assets by transferring the assets to two new plans and trust, terminating one of the plans and trusts, and reverting the surplus assets of the terminated plan and trust to itself. *Id.*

Similarly, the Court of Appeals of the District of Columbia used the functional test to determine that insurance proceeds received by a corporation for flood damage done to its manufacturing facility in Virginia constituted business earnings. *District of Columbia v. Pierce Assocs., Inc.*, 462 A.2d 1129 (D.C. 1983). The court held that the facility furthered the company's business of furnishing and installing mechanical systems because it had been treated as part of the business for tax purposes. *Id.* at 1132. Specifically, the court found that Pierce had deducted from its District of Columbia income taxes expenses incurred in

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earnings cited within this Memorandum and Order use the same language as California.

maintaining the plant and took depreciation deductions for wear and tear on the facility. *Id.*

In *Ross-Araco Corp. v. Bd. of Fin. and Revenue*, the Supreme Court of Pennsylvania held that income received by a corporation from the sale of 21.5 acres of land was not business income. 674 A.2d 691 (Pa. 1996). Applying the functional test, the court considered the fact that the corporation owned the property and included it as collateral for the purpose of obtaining performance bid bonds that benefitted the business. *Id.* at 696-697. The court, however, concluded that the property was never improved or used in the construction business and stated:

> [the property's] purchase was incidental to the acquisition of the 3-acre tract of which there was a building suitable for storage of equipment and material used by Ross-Araco in its construction activities. There is no indication that the 21.5 acres were purchased to expand Ross-Araco's investment portfolio which was used as collateral to secure performance bid bonds.

Id. at 697. In deciding that the proceeds from the sale were not business income, the court further noted that the property did not produce income during Ross-Araco's ownership. *Id.* at 696-697.

The North Carolina Supreme Court applied the functional test to a case involving liquidation and cessation of a separate and distinct operating division.

Lenox Inc. v. Tolson, 548 S.E.2d 513 (N.C. 2001).[4] The court held that "when the transaction involves a complete or partial liquidation and cessation of a company's particular line of business, and the proceeds are distributed to shareholders rather than reinvested in the company, any gain or loss generated from that transaction is nonbusiness income under the functional test." *Lenox Inc.*, 548 S.E.2d at 518.

Lastly, both Pennsylvania and Illinois applied the functional test in cases involving the sale of pipe lines. In *Laurel Pipe Line Co. v. Bd. of Fin. and Revenue*, the issue before the Pennsylvania Supreme Court was whether proceeds resulting from the sale of a pipeline were business earnings taxable by Pennsylvania. 642 A.2d 472 (Pa. 1994). After applying the functional test, the court concluded that the income received from the sale was not an integral part of the business but rather a liquidation of a portion of the business assets. *Id.* at 475. The court reached this conclusion based on the findings that the proceeds of the sale were not reinvested back into the operations of the business but instead were distributed entirely to the stockholders of the corporation. *Id.* The court further concluded, contrary to the Board's position, that the pipeline was not necessary to maintain the "continued, overall business viability" because:

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[4] The language of the North Carolina statute differs slightly from the other state statutes used within. Specifically, it provides that business income is "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible or intangible property if the acquisition, management, **and/or** disposition of the property constitutes integral parts of the taxpayer's regular trade or business." *Lenox Inc. v. Tolson*, 548 S.E.2d 513, 513 (N.C. 2001).

> the gain on the sale was not reinvested in to assets that could be used by the company nor was it invested in financial securities that would generate income for the company. To the contrary, dividends were declared equal to the amount of the entire after-tax net proceeds from the sale of the pipeline and distributed to the shareholders of the corporation.

Id. at 476.

The Illinois Supreme Court applied the functional test to a similar situation but found that the income received from the sale of the pipeline was business income. *Texaco Cities Serv., Pipeline Co. v. McGaw*, 695 N.E.2d 481, 486 (Ill. 1998). Unlike the court in *Laurel Pipe Line*, the Illinois Court found that: Texaco-Cities indicated on its tax return that its business was pipeline transportation; the pipelines sold were among several that Texaco-Cities used to transport petroleum and other substances in the regular course of its business; and the pipeline at issue was used for the production of business income. *Texaco-Cities Serv.*, 695 N.E.2d at 486. Also noteworthy to the court was that after the sale, Texaco-Cities remained in the business of providing transportation by pipeline and the proceeds of the sale were reinvested back into the business rather than being distributed to its shareholders. *Id.* at 487.

Guided by the above case law, the Court turns to the factual record to examine the acquisition, use, management and disposition by the plaintiff of the BBC USA stock to determine if it constitutes an integral part of the taxpayer's regular trade or business operations.

Examining first the acquisition of the property, the Court finds that the parties' Statement of Undisputed Material Facts provide that the capital gains resulted from the plaintiff's almost passive acquisition of BBC USA stock from BBC USA shareholders. The acquisition of the stock was not created by the plaintiff, as the liquidated pension plan had been by the taxpayer in *Hoechst*, nor was the stock used by the plaintiff to further its business, such as pledging it as collateral, as in *Ross-Araco Corp*. Accordingly, the acquisition of the stock in this case was not integral to plaintiff's business.

The factor of management is not presented by this case because the stock was instantly redeemed.

Unknown are facts as to the use or disposition of the proceeds paid for the stock by BBC USA to the plaintiff in the stock redemption. The plaintiff claims the money received from the stock was redistributed to the shareholders. To the contrary, the defendant claims the income received from the redemption of the stock was deposited by plaintiff into its business and used in the business. Missing, though, are any Statements of Undisputed Material Facts or citations to the record of facts concerning the use and disposition by the plaintiff of the proceeds of the stock to back up the opposite assertions made by the parties.

Use and disposition of the property is a critical inquiry in the functional test in the cases discussed above. Without such facts, the Court is unable to determine whether the earnings in issue are business or nonbusiness earnings and is unable to rule on the second part of the case. Were the constitutional issues not dispositive of the case, a trial would need to be

conducted to obtain evidence on the use and disposition by the plaintiff of the proceeds of the stock redemption transaction.

The Court, therefore, grants plaintiff's motion for summary judgment and denies defendant's motion for summary judgment based upon the Court's decision that the federal Constitution does not permit the tax assessment in issue. The plaintiff's attorney shall prepare a final order for a refund, stating the precise amount, addressing the issues of interest and attorneys fees, and taxing costs to the defendant.

/s/ Ellen Hobbs Lyle
ELLEN HOBBS LYLE
CHANCELLOR

cc: James Bradshaw III
Brad H. Buchanan

APPENDIX E

**IN THE CHANCERY COURT
FOR THE STATE OF TENNESSEE
TWENTIETH JUDICIAL DISTRICT,
DAVIDSON COUNTY, PART III**

Docket No. 06-414-III

[Filed August 15, 2008]

BLUE BELL CREAMERIES, LP,	)
	)
Plaintiff,	)
	)
v.	)
	)
LOREN L. CHUMLEY, COMMISSIONER, DEPARTMENT OF REVENUE, STATE OF TENNESSEE	)
	)
Defendant.	)

MEMORANDUM AND ORDER

Plaintiff Blue Bell Creameries, LP, a Delaware-based limited partnership that does business in Tennessee, has filed this lawsuit against the Commissioner of Revenue seeking a refund for money it paid to the State in taxes for the 2001 tax year. Defendant assessed plaintiff $146,025.25 in excise tax

of which $120,676.61 is at issue in this case.[5] Under Tennessee Code Annotated § 67-4-2007, corporations are required to pay the State an excise tax on their net earnings for business done in Tennessee. One of the definitions of net earnings under Tennessee law is income reported by the taxpayer on its federal income tax return. In this case, plaintiff reported $119,909,317 as total capital gain that it received from a momentary holding of stock for Blue Bell Creameries, USA, Inc., (hereinafter BBC USA), a privately owned holding company that owns the assets, properties, and related businesses and legal entities that develop, sell, and operate the business and products commonly known as Blue Bell Ice Cream. The stock redemption was a one-time reorganization transaction of BBC USA.

Defendant claims the capital gain is taxable because it constitutes net earnings. Plaintiff denies this, arguing that under federal constitutional law, the stock redemption transaction that was the source of the capital gain cannot be taxed by Tennessee because it lacks a sufficient connection to plaintiff's in-state business activity. Both sides use the unitary business principle developed by the United States Supreme Court to analyze the connection between plaintiff's capital gains from the stock redemption and the business it regularly does in Tennessee.

The case is presently under advisement before the Court on cross motions for summary judgment. After studying the record and arguments of counsel, the Court requires supplemental briefing from the parties as follows.

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[5] Mem. in Supp. of Comm'r Mot. for Summ. J. at 5-6.

Although numerous courts have analyzed and applied the unitary business principle, few have done so in the context of holding companies. At least one decision, however, has specifically discussed whether holding companies can form a unitary business with operating companies. *In the Matter of the Appeals of PBS Bldg. Sys., Inc., et al.*, 1994 Cal. Tax LEXIS 434 (Nov. 17, 1994). The decision in that case established that there was no *per se* rule that holding companies are non-unitary. *Id.* at *7. In other words, depending on the facts of each individual case, a holding company can be unitary with an operating company. *See generally A.B. Dick Co. v. McGraw et al.*, 678 N.E. 2d 1100 (Ill. App. Ct. 1997)(stating that the fact that a holding company owns controlling interest in several corporations is not sufficient to make the group a unitary business) and *The First Nat'l Bank of Manhattan v. Kansas Dep't of Revenue*, 779 P.2d 457 (Kan. Ct. App. 1989)(finding that a holding company was not unitary with its operating company). The *PBS* decision further established that to determine whether holding and operating companies are unitary, no special test exists but rather the standard test for unitariness applies, i.e. there must be unitary activities between two companies to establish a unitary business under the principles set out in *Allied-Signal v. Director, Division of Taxation. In re PBS*, 1994 Cal. Tax LEXIS 434, *11.

For example, the record must establish concrete advantages that the operating company obtains from the holding company, such as insulation from liability, shared tax benefits, intercompany financing (loans, loan guarantees, and debt retirement) or improved credit worthiness (bond security, more favorable insurance rating or interest rates on borrowed capital).

Id., *14. Common ownership alone is not sufficient for a unitary business. *A.B. Dick Co., v. McGraw*, 678 N.E. 2d 1100, 1102 (Ill. App. Ct. 1997). "The fact that a holding company owns controlling interest in several corporations is not enough to make the group a unitary business." *Id.* (citing *Mobil Oil Corp., v. Comm'r of Taxes*, 445 U.S. 425, 440 (1980)). "There must be something 'beyond the mere flow of funds arising out of a passive investment or a distinct business operation.'" *Id.* (citations omitted). "There must be more than the type of occasional oversight 'that any parent gives to an investment in a subsidiary." *Id.* (citing *Container Corp., v. Franchise Tax Bd.*, 463 U.S. 159, 180 (1983)).

In considering this law and the record in this case and in working its way through the analysis of the motions for summary judgment, the Court's impression is that the only statement of a concrete advantage of the stock redemption transaction to plaintiff, located in the Statement of Undisputed Material Facts, Pleadings, and the Deposition of Mr. Rankin, is number 7 of plaintiff's response to defendant's Statement of Undisputed Material Facts:

> The Reorganization which was carried out from November 2000 through January 1, 2001, was undertaken for the purpose of allowing Blue Bell USA and the Business as a whole to
>
> remain a private company for an indefinite period of time, thereby avoiding the expense and inconvenience of registering its securities and publicly reporting its financial results and so that its stockholders may receive 'pass-through' tax treatment after effecting the

> transactions contemplated in this Second Amended and Restated Plan of Reorganization (the 'Plan') by qualifying Blue Bell USA or its successor, as an S corporation, as defined in [Internal Revenue] Code section 1361. Because the operations of the business are conducted by the Existing Partnership, which is currently Blue Bell USA's lowest tier subsidiary, to achieve pass-through tax treatment, each of the subsidiaries within Blue Bell USA's affiliated group must also receive pass-through tax treatment. Accordingly, upon effecting the transactions contemplated under this Plan ('the Reorganization), Blue Bell USA will cause each of the Existing General Partner, the existing Limited Partner and the Existing Partnership and any other wholly-owned subsidiaries that are treated as associations taxable as corporations for federal income tax purposes, to become a qualified subchapter S subsidiary, as defined in Code section 1361.

The point on which the Court needs additional briefing is that Statement 7 above asserts that there are tax advantages and non-registration and non-reporting of securities, both to plaintiff and BBC USA. The Second Amended and Restated Plan of Reorganization attached to Mr. Rankin's deposition, however, provides that these advantages apply only to BBC USA.

Accordingly, to assist the Court in analyzing the functional integration between plaintiff and BBC USA under the *Allied-Signal* unitary business principle, the Court ORDERS the Commissioner to file on or before September 5, 2008, a supplemental brief explaining

the concrete tax advantages and non-reporting and non-registering of securities advantages plaintiff received from the stock redemption and where in the record these advantages are proven. The Commissioner need not reargue any implicit advantage or trickle down advantage plaintiff receives as that was adequately discussed in oral argument. The Court seeks identification of concrete advantages to plaintiff. The plaintiff shall file a response brief by September 12, 2008. The Commissioner shall file a reply by September 16, 2008.

It is so ORDERED.

/s/ Ellen Hobbs Lyle
ELLEN HOBBS LYLE
CHANCELLOR

cc: Brad Buchanan
James Bradshaw